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Report of the Commission of Inquiry into Residential Tenancies Volume II

Report of the

Commission of Inquiry into Residential Tenancies

Volume II

Stuart Thom
Commissioner

April 1987



Ontario

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Order in Council

The following is the text of Order in Council #3092/82 as amended by Order in Council #2504/83, approved by His Honour the Lieutenant Governor on the recommendation of the Minister of Consumer and Commercial Relations.

On the recommendation of the undersigned, the Lieutenant Governor, by and with the advice and concurrence of the Executive Council, orders that

Pursuant to the provisions of the *Public Inquiries Act*, R.S.O. 1980, Chapter 411, Mr. STUART D. THOM, Q.C., be appointed as a Commissioner,

1. to examine, study and inquire into the laws of Ontario, including the statutes and regulations passed thereunder affecting residential tenancies in Ontario for the purpose of determining,

   (a) the equity of the current system of rent review, having regard for the rights and interests of both the landlord and the tenant;

   (b) the effect of rent review on the level of rental rates and the supply of residential accommodation in the Province;

   (c) whether a more expeditious procedure should be applied to the review and decision-making process of the Residential Tenancy Commission in view of the issues being raised, the rights of appeal and the need for timely decisions;

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(e) the advisability of integrating the *Landlord and Tenant Act* with the provisions for rent review as was contemplated by the *Residential Tenancies Act* prior to the decision of the Supreme Court; and

(f) any other changes in such laws, procedures and processes necessary and desirable to provide for the fair and equitable treatment of landlords and tenants under a system of rent review.

2. to recommend such changes in the laws, procedures and processes as in the opinion of the Commissioner are necessary and desirable to provide for the fair and equitable treatment of landlords and tenants under a system of rent review; and

3. to recommend what measures, in addition to rent review, the Province of Ontario might take to assist in providing rental accommodation at fair rents for living accommodations to which the *Residential Tenancies Act* applies.

It is further ordered that all Government Ministries, Boards, Agencies and Commissions, shall assist Mr. Thom to the fullest extent in order that he may carry out his duties and functions, and that he shall have authority to engage such counsel, expert technical advisors and other staff as he deems proper at rates of remuneration and reimbursement to be approved by the Management Board of Cabinet, and that the Ministry of the Attorney General will be responsible for providing administrative support to the Inquiry.

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*Some counsel and agents appeared only during one phase of the Inquiry's hearings.

Executive Summary

Rent regulation, introduced in Ontario in 1975 as a temporary measure, has now been in place for more than a decade. The evidence presented in Chapter 1 shows that on average regulation has held rents for controlled rental units below normal market levels. However, while the average rate of rent increase for those units has been slowed, regulation has not protected all tenants against large increases in particular instances.

There is no conclusive empirical evidence on the extent to which controlled rents have been held down. Estimates of competent analysts range from 7.5 per cent to 10 per cent on average. This represents several hundred million dollars annually that tenants do not pay in rent which otherwise would have been paid. Conversely the existence of controlled rents has resulted in the payment of higher rents than otherwise would have been paid by tenants in uncontrolled units. The benefit of reduced rents extends to all tenants in controlled units but only a disproportionately small part accrues to low-income households. The evidence indicates that the monetary benefit to tenants with incomes below the median level is about one quarter of the benefit to those with incomes above the median. It can be assumed that the latter class of tenants could have afforded to pay market rents.

The current system of rent regulation was a scheme brought into operation to deal with a political situation in 1975. When the legislation was passed by the legislature, it was not intended to be a permanent answer to problems in the rental market. For the reasons developed at length in the Report, the Inquiry believes it should be revoked. The Inquiry does not say however that there should be no rent regulation at all. In the unregulated market tenants are exposed to the risk of being charged excessive rents known as gouging and economic eviction, and to sharp increases in the general level when the market supply is short. There is also the alleged but not proven possibility that landlords

could make excess profits over a long-term period by charging rents in excess of fair market rents.

The directive to the Inquiry in the Order in Council is that landlords and tenants should be given "fair and equitable treatment under a system of rent review." This can only be achieved by a system of rent regulation which allows landlords to charge fair market rents accompanied by policies which provide financial assistance to tenants who are unable to pay market rents. The issue of fair rent is examined in detail in Chapter 2. Fairness to both landlords and tenants cannot be achieved by rent regulation alone as demonstrated by the experience in Ontario since 1975.

Rent regulation in Ontario has been an unsatisfactory compromise. Rents have been reduced to below market levels with most of the benefit going to tenants who could have paid market rents. Private investors who might have invested in rental housing stayed out of the market with the result that the supply of new housing was inadequate. Those who were in the market have actively sought to disinvest by demolishing and converting their properties and reducing service. Vacancies have fallen to a low level and have become almost non-existent in some areas. Low-income tenants have enjoyed some benefit but rents are still too high to allow them to obtain decent, adequate housing with their own limited resources. Landlords have not been treated equitably since only in limited circumstances do the rents which can be charged include an adequate return on equity. The government has been called upon in lieu of private sector involvement to invest heavily in rental housing for the benefit of low and middle income tenants; but the demand is not nearly satisfied.

The Fair Market Rent System

Having reviewed alternative forms of rent regulation and other rental housing policies (see Chapter 3), the Inquiry urges the adoption of a different system of rent regulation combined with budgetary policies to replace the current system. The Fair Market Rent (FMR) system of regulation proposed by the Inquiry has been devised to allow rents to rise to fair market levels and no higher thereby restoring normal private investment while protecting tenants. It is described in Chapter 5. At the same time shelter allowances should be paid to low-income tenants to allow them to afford market rents for suitable housing. Government funding of socially assisted housing would continue to be required. New private supply, however, would serve to replenish the supply of middle rent housing and would ease the burden on government finances. Favorable developments in the market as contemplated above would require time to materialize. They would be realized only when government is able to convince private investors that its commitment to a regime of fair market rents would be long term.

The Fair Market Rent system combines rent control and rent review mechanisms and, for its effective implementation there should also be a rent registry. One component would be fair return rent control which involves a guideline rate of rent increase which would operate at the industry level. The main feature of the review component would be a market comparison review process operating at the individual building level.

Under fair return rent control, the guideline rate of increase for the industry would be set annually by a Guideline Board and would be the rate required to allow the current actual rent level in the industry to rise to the projected fair market rent level in the following year. (See Chart 2 in Chapter 5 which shows the organizational structure and responsibilities for the operation of the FMR system.) Refinements would include setting guideline rates of increase in regions of the province rather than province-wide: also if the gap between the current actual rent level and the projected fair market rent level were found to be too large to be closed in one year, the rate of increase could be phased in over a period of years. The Guideline Board would hold annual hearings to set the guideline rate of increase. Data regarding the current actual industry level, the required rate of return for the industry, current costs and projected cost increases would be obtained by the Staff of the Guideline Board from an examination and analysis of information provided by a representative sample of landlords across the province. From these data, the current and projected fair market rent levels would be determined.

Market comparison reviews would be conducted by Review Officers, collectively referred to as the Rent Review Commission, at hearings held throughout the province at the request of the landlord or tenants of a complex who felt that rents for the units in their complex were below or above the average for the rents of similar units in other complexes in the area. An administrative official would identify a group of comparable complexes and ascertain the rents for the units therein. This information would be assembled and analyzed by the official and presented to the Review Officer for determination of adjustments which should be made to the rents for units in the complex under review. Such adjustments might increase or decrease the existing rent of a unit to bring it to the average rent of similar units in the comparable buildings. It would be combined with the guideline rate of increase for the year and the combined amount would be the rent ordered by the Review Officer for the unit. Refinements to the operation could include phasing in substantial adjustments, and schedules of variances among units and complexes prepared by the Guideline Board for the use of Review Officers where comparable complexes were not available.

The intent of the Fair Market Rent system is that annual guideline rent increases accompanied by market comparison review adjustments would ensure that landlords are permitted to charge fair market rents and no more. Surveys

of the industry rent level would continue to be conducted annually and when it was found that the actual rent level was at the fair market rent level, the guideline rate of increase would equal the rate of increase in the fair market rent level — thereby protecting tenants from having to pay excess rents.

FMR regulation as proposed by the Inquiry would include a variation of the market comparison review process in the form of single building review. Such review would be conducted by Review Officers and could be called for at any time by the landlord or the tenants. The review would equalize rents within the building and would provide relief for a tenant who was charged an excessive rent or was threatened with economic eviction.

The system of regulation recommended by the Inquiry is a different approach to the regulation of residential rents than cost pass-through but is not a new idea. It is an adaptation of the approach to price regulation which has been used to regulate prices in a number of industries for many decades making it more suited to the rental housing industry. The general principles are founded on long-established experience in setting prices that protect consumers while ensuring that the industry being regulated remains healthy and able to meet the needs of consumers.

Market Problems Dealt With by the FMR System

The design of the FMR system is based on an analysis of the problems associated with the rental housing market which was required in order to identify the objectives of rental housing programs (see Chapter 4). Problems facing tenants in the rental housing market which are inherent in the operation of the market are excessive rents charged to immobile or unwanted tenants, high rents during periods of inadequate supply and excess profits.

An excessive rent is defined in this Report as a rent which is higher than rents for similar units of equal value and is popularly described as gouging. In its extreme form gouging may be an unconscionable rent increase where a landlord takes advantage of a tenant household's inability or disinclination to move or to find other accommodation the household could afford. An excessive rent charge can also be a rent which the landlord knows an unwanted tenant cannot pay and therefore will have to move. This practice is known as economic eviction. Excessive rent charges would be controlled by the market comparison and single building rent review features of the FMR system.

Abrupt escalations of rents above the prevailing market level are disturbing to tenants and call for regulation. Such events can be caused by an unexpected increase in demand with resulting supply shortage. Such occurences call for a policy of rent control which would be provided by the guideline rate under the FMR system. The advantage of the FMR guideline rate of increase is that it would be related to the fair market rent level while an arbitrary guideline

rate introduced on a temporary basis would carry the risk of being too low, thereby aggravating the shortage of supply, or too high so that protection for the tenants would be inadequate.

The problem of possible excess profits also would be dealt with by the FMR system. Under this system, the rent level would be monitored and if it were found that the industry fair market rent level had been exceeded, a guideline increase less than the increase in the fair market rent level could be imposed. An integral feature of the Fair Market Rent system is a constant survey of the rent level and industry costs which would determine the rate of increase in the industry fair market rent level.

There are other problems in the rental market which are associated with restrictive rent regulation, namely an inadequate supply of housing and inadequate maintenance of the existing stock. Units for upper income tenants have never been in short supply. The lack of available rental housing becomes increasingly a problem as household income levels diminish. Even as it is, the overall statistics of vacancy levels prepared by CMHC, which do not distinguish availability in relation to income, are abnormally low. Restrictive rent regulation which has discouraged investment in new supply and led to disinvestment of existing stock by way of demolition and conversion to other than rental housing uses is the major reason for the existing situation. Socially assisted housing funded by government can do something to relieve the problem for tenants most affected but the market will be restored to normal only in an unregulated market or under the FMR system which will allow the rental industry to earn a fair return on its investment, but no more.

The Affordability Problem

The unaffordability of rental housing is a commonly expressed reason for rent regulation. It is observed that the so-called affordability issue is essentially a matter of some tenant households having insufficient income to provide them with the necessities of life, one of which is decent housing suitable to their needs. Housing as such may be cheap or costly but does not have an inherent quality of being affordable or unaffordable. The real question is whether housing suitable to the tenant's need is affordable by the tenant. For many households this is not the case but it should be recognized that they have an income problem not just a housing affordability problem.

The difficulty low-income households have in paying rent can be alleviated somewhat but, except for a marginal few, cannot be eliminated by a system of rent regulation which holds rents below the market level they otherwise would have to pay. The many adverse consequences of such a system render it an unsatisfactory response to the affordability problem of low-income tenants. They should, however, be given assistance and this is best done by budgetary

policies funded by government in the form of shelter allowances and by subsidized housing in which those who are admitted would pay rent geared to their incomes. Until a genuine incomes policy is established, government budgetary policies focussed on making rental housing more affordable by low-income tenants are necessary and should be pursued vigorously.

The Transition to a Balanced Market

After implementing the FMR system, the problem of assuring the industry that restrictive regulation will not be reintroduced will remain. Until confidence in the stability of a system of moderate regulation is established, investors will be slow to risk substantial new investment. In the interim government may be required to underwrite new supply.

The Fair Market Rent system of regulation proposed by the Inquiry is not a simple one. It is however the only feasible long-run approach to regulation. The cost pass-through system is inadequate because it is not capable of setting allowable rents that are fair to both landlords and tenants. Fairness cannot be achieved without considering both the industry return on equity and the initial rent level. The fair market rent system will involve cost in the way of personnel but probably will not greatly differ from the cost of the administrative staff under the current legislation. With regard to cost, the Inquiry's proposal does include possibly greater budgetary expenditures by government than is now the case in the form of direct financial support for low-income tenants who cannot pay fair market rents. This is an outlay that in the opinion of the Inquiry should be made in any case.

It is a political decision for government whether rents should be regulated and in what manner. Whatever form of regulation may be adopted it must deal fairly and equitably with investor/landlords and tenants. There is no simple and inexpensive form of regulation which will deal adequately with the problems in the rental housing market and still be fair and equitable. In the opinion of the Inquiry the FMR system meets the criterion of fairness and equity and the present cost pass-through system does not.

Acknowledgements

The members of the group who were so immensely helpful in the conduct of the first phase of this Inquiry and the production of Volume 1 of the Report continued their association with the Inquiry with unabated energy.

John Todd's depth of understanding of economics and of the rental housing market in particular provided the necessary and essential bridge between the Commissioner's lay understanding of the those matters and the technical evidence given by witnesses and embedded in research material. The credit for the research group and the invaluable library of publications which has resulted from it are entirely his.

Preparation for hearings and the orderly presentation of evidence was not so time consuming in the second phase as it had been in the first phase. Consequently the skill and energy of Don Jack, counsel to the Inquiry, were largely left free to the production of the research studies commissioned by the Inquiry. It was a pleasure to read that his services in this regard were noted in the foreword to several of those studies.

Thelma Hershorn's vigorous and efficient attention to the administrative side of the Inquiry was maintained to the end. Her blend of diplomacy and firmness when required combined with unfailing good humor kept the operation moving along without disruptions.

The research staff who numbered three at the beginning of phase two was reduced to Eric Adams at the conclusion as John Pringle and Pearl Ing moved to new endeavors. All contributed substantially to the important body of research material. Eric Adam's work on the Appendices was particularly important. Miriam Brown provided her own special skill as computer programmer for the preparation of statistical material.

Ronit Little performed with great efficiency the function best described as that of administrative assistant which was to keep track of the seemingly

endless drafts, rewrites and revisions of material that eventually became the finished Report. She also worked in word processing with Carroll Brooks until Carroll left early in the second phase when Ronit succeeded her in that department.

Pertinent editorial comment and guidance on style and syntax were provided by Jacqueline Boyle Allen who guided the Report through its final printing stage. Bob Kosonic was always helpful as photocopier and in other ways.

The Inquiry continued to benefit from excellent relations with Roland d'Abadie of the Ministry of the Attorney General and his assistant Inge Sardy.

I would again take this opportunity to thank my long suffering wife for her continuing support and patience.

Glossary

Affordability Gap	the difference between the actual rent for a unit and the socially fair rent limit for the household occupying that unit.
BOCI	Building Operating Cost Index — prescribed in Schedule A to the 1986 Act
CAPM	capital asset pricing model
CMA	census metropolitan area
CMHC	Canadian Mortgage and Housing Corporation
Commission	Residential Tenancy Commission under the 1979 Act
Competitive Return	equals the return which could be expected on alternative investments involving similar risk
CPI	consumer price index
DCF	discounted cash flow
Efficiency Risk	risk associated with the cost of operating a building relative to the average cost of operating that type of building for all landlords
Fair Market Rent Level	the minimum rent level sufficient for the industry to earn a fair return
FMR	Fair Market Rent System — the rent review system proposed by this Inquiry to provide landlords with an adequate return on their investments and protect tenants from being charged rents which exceed fair market rents
Fair Return	when the industry long-run return on investment equals the return which could be expected on alternative investment involving similar risk
Gouging	charging a rent above the prevailing market rent for comparable units
Guideline	fixed limit or ceiling on rent increases
HIFE	Household Income, Facilities and Equipment Survey
Inquiry	Commission of Inquiry into Residential Tenancies

IRR	internal rate of return
LIC	low-income cut-off
Low-middle-income	households with incomes above the LIC but less than twice the LIC
Market Rent	actual rent which would be charged in the absence of a rent regulation system
MMAH	Ministry of Municipal Affairs and Housing
Moderate Regulation	a non-restrictive system which allows landlords to earn the competitive rate of return on their investments while limiting opportunities for rents to rise above the fair market level
MURB	Multiple Unit Residential Building program
NPV	net present values
OHC	Ontario Housing Corporation
RCCI	Residential Complex Cost Index — prescribed in Schedule B to the 1986 Act
RE	return on equity
Rent Control	a ceiling or limit on rent increases uniformly applied by legislation or regulation to all rental units or specified portions of the total market
Rent Review	an administrative process whereby rents or rent increases, are determined by a government official or tribunal
Rent Seeking Activities	lobbying and procedural costs (See section 1.5.1)
Rental Unit	does not include a room in a boarding house or lodging house
Restrictive Regulation	a system which holds rents below the fair market rent level
RTC	Residential Tenancies Commission under the 1979 Act
Socially Assisted Housing	housing whose construction and/or operation is subsidized by government

Socially Fair Rent	the rent a tenant household can afford to pay for adequate accommodation
SPCMT	Social Planning Council of Metropolitan Toronto
Tenant Household	One person or several persons at one time, who occupy a residential rental unit as a tenant or tenants
Upper Income	more than twice the LIC
1975 Act	Residential Premises Rent Review Act, 1975 (2nd Session), S.O. 1975 (2nd Session), c. 12.
1979 Act	Residential Tenancies Act, R.S.O. 1980, c. 452.
1982 Act	Residential Complexes Financing Costs Restraint Act, 1982; S.O. 1982 c. 59.
1986 Act	Residential Rent Regulation Act, 1986; S.O. 1986 c. 63.

Definitions in the Residential Tenancies Act, and the Residential Rent Regulation Act, 1986 are followed in the Report unless otherwise noted.

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Table 1: Rent Escalation Under the FMR System

Introduction

The Order in Council establishing the Commission of Inquiry into Residential Tenancies assigned two tasks to the Inquiry.[1] Stated in a most general way they were to review the existing situation and the prevailing scheme of rent regulation and to look into the future of regulation and the rental housing market. The work of the Inquiry accordingly has been conducted in two phases. In the first phase the Inquiry reviewed and reported on rent regulation as it was functioning in Ontario.[2] In the second phase the Inquiry examined the effects and consequences of rent regulation and considered what improvements or changes should be made to render it fair and equitable to landlords and tenants. The Inquiry also considered what other measures should be taken "to assist in providing rental accommodation at fair rents." The Inquiry's findings and recommendations arising from the second phase of its operation are contained in this Volume of its Report.

The first phase occupied the time of the Inquiry in 1983 and into 1984 and was concerned with the operation of the system of rent regulation under the statutes of 1975, 1979 and 1982 and with matters directly related to it.

1. The Commission of Inquiry into Residential Tenancies is referred to as the Inquiry to avoid confusion with the Residential Tenancies Commission which administered rent regulation under the 1979 legislation and now has an appelate function under the 1986 legislation. It is referred to as the Commission.

2. The terminology of the Order in Council is "rent review." The scheme under the legislation of 1975, 1979 and 1986 is a dual operation combining processes identified as rent control and rent review. The Inquiry adopted the comprehensive phrase of "rent regulation" when referring to the totality of the operation. That terminology is used in the 1986 legislation.

   The Inquiry has not interpreted the Order in Council as having ordered that the existing combined rent control and rent review scheme either as it stands or with amendments is the final word on regulation.

The Inquiry's findings and recommendations in that regard are contained in Volume 1 of the Report. It was said in the Introduction to Volume 1, "The Inquiry has conducted its study of rent regulation in Ontario under the current legislation without reference to alternative schemes or the broader aspects of rent regulation." Volume 1 was neither an affirmation nor a condemnation of the existing system. The Inquiry took the position that its immediate task was to bring forward recommendations designed to improve the day-to-day operation of the system while leaving its general features largely untouched.

A matter frequently referred to in the first phase of the Inquiry was landlords' return on equity. It was noted in Volume 1 that the 1979 Act does not take that factor into account. The issues arising with regard to return on equity were reserved for consideration in the second phase (see Volume 1, p. 114). Return is an integral part of the analysis presented in this Volume of the Report.

Rent Regulation: A Continuing Policy

The Order in Council does not ask the Inquiry to consider whether or not there should be rent regulation in some form. The question cannot be avoided however, because the answer to why rent regulation should be a continuing policy of government will have an effect on the form regulation should take and that is a matter of direct concern to the Inquiry.

A study of the social, economic and political forces which in 1975 brought about the imposition of rent regulation in Ontario and why it is likely to remain a policy for the indefinite future, is contained in a research paper prepared for the Inquiry by Stanbury and Thain (1986). The authors identified what they called "strands of a theory of rent regulation in Ontario." (p. 5-6). They were:

> 1. Economic pressure — sharp increases in rents. The statistics do not provide a clear picture of the actual situation in 1975 but it was enough to disturb the tenant population. It was accompanied by a rising inflation rate of more than 10 per cent in both 1974 and 1975, rising unemployment and a slowing in the growth of per capita income.
> 2. Political pressure — in part due to the development of tenant organizations.
> 3. Political competition and what the authors called "entrepreneurship", i.e. activities which can raise a latent issue to an overt one and can make a smaller political issue into a larger one.

There is no indication that strands 2 and 3 are any less potent now than they were in 1975.

4. Potentially constraining political ideology. In 1975 the political party which formed the government was adverse to rent regulation but its aversion was overcome by political events.

Today no political party opposes rent regulation.

5. Precedents — other provinces had introduced rent regulation and it was well known in the United States, the United Kingdom and western Europe.

6. Federal wage and price controls — the federal anti-inflation program was announced in October, 1975, accompanied by a statement asking provincial governments to implement rent control.

If these strands of a theory can be considered as reasons for rent regulation, they do not go below the surface events and examine the problems which gave rise to the tenant pressure (it certainly was not landlord pressure), that had such a powerful effect on politicians. This is a topic of Chapter 4 of this Volume of the Report.

Because it was and continues to be tenant power which underlies rent regulation, an awareness of the arguments underlying the tenant position is necessary background for a study of rent regulation. A recital of these arguments is neither to refute nor support them. They can be stated as follows:

1. Rental housing is a unique commodity unsuited to market allocation.

2. Regulation is just one of many types of government intervention required to protect people from the sometimes insensitive and unfair workings of the market.[3]

3. In a study prepared for the Inquiry entitled *Residential Tenancies: Losses, Fairness and Regulations*, it is said:

> There are several reasons why it is important to know what the public considers fair in the domain of rental housing. The first and most obvious is that residential tenancies are heavily regulated and that the political and legislative process that produces regulations is certainly affected by the prevailing standards of fairness. Another reason to study public attitudes is to understand why the pressure to regulate tenancies is so strong.
>
> The discrepancy between the popular view of rental housing and the approach of most professional economists is large and obvious. *A large proportion of the public favours strong restrictions on landlords, including rent controls*, which are considered to be inefficient and selfdefeating by almost all economists, regardless of their politics. (Knetsch, et al. (1984), p. 16, emphasis has been added)

3. Tenants are exposed to gouging and excessive rent increases.

4. The market is subject to sharp and disturbing fluctuations.

5. Regulation is required to retain a stock of affordable housing, to give reality to security of tenure, and to preserve the social and economic characteristics of neighbourhoods.

6. Landlords are making excess profits.

The foregoing recital may not be an exhaustive list of the arguments advanced in support of rent regulation but it conveys the underlying distrust of the unregulated market by an element of the tenant population. They feel the unregulated market is not acceptable as a mechanism to govern the supply and allocation of rental housing.

In 1975, tenant advocates were successful in gaining ascendancy over government rental housing policy in Ontario. The story of their crusade is dealt with at length in Stanbury and Thain (1986). The reasons for the continuation of rent regulation today as a government policy (note the all-party support given to the 1986 Act in the legislature) may not be the same as those which prevailed in 1975 but there is little indication of a reversal of that policy in the foreseeable future. The Inquiry's opinion on the future of rent regulation is found in section 6.2 of this Report.

Directives to the Inquiry Regarding Rent Regulation

The Order in Council directed a number of topics to the attention of the Inquiry. Three matters were deferred for consideration in the second phase of its operations. The weightiest and most important of these is the injunction in subparagraph 1(f) to determine what changes in the law are required to provide for the fair and equitable treatment of landlords and tenants under a system of rent review.[4] To emphasize its importance this injunction is repeated in paragraph two of the Order in Council as a directive and its scope is amplified by paragraph three which calls for recommendations regarding other means which might be undertaken to bring about a regime of "fair rents."

A second directive, found in paragraph 1(a) of the Order in Council, is to determine "the equity of the current system of rent review having regard to the rights and interests of both the landlord and the tenant."

A third directive to which attention was given in the second phase of the Inquiry, is found in subparagraph 1(b) of the Order in Council. The Inquiry

4. The Inquiry has interpreted the phrase "a system of rent review" as meaning a scheme or system of regulation of rents, whether or not similar in nature to rent regulation in Ontario, which intervenes in the operation of the free market or replaces it in some way.

is directed to determine "the effect of rent review on the level of rental rates and the supply of residential accommodation in the Province."

Organization of the Report

Chapter 1 contains a factual report of the dimension and characteristics of the rental housing market in Ontario and describes the effect and consequences of rent regulation in Ontario. This is necessary background to an understanding of the market's complexities and problems. As well, the Chapter discusses the indirect cost of regulation and its distributive impact. Fairness is the essence of the directives to the Inquiry and the Inquiry's understanding of fairness is the subject of Chapter 2. Chapter 3 reviews on a conceptual and practical basis regulatory schemes which have been employed to deal with the problems; it also identifies complementary programs in the form of budgetary programs which provide subsidies and allowances to landlords and tenants, and institutional policies as expressed in the Landlord and Tenant Act, as well as zoning and housing regulation bylaws. In Chapter 4 the problems in the rental market are identified and discussed, with consideration given to how far regulation can go in resolving those problems. Chapter 5 presents the Fair Market Rent (FMR) system of rent regulation put forward by the Inquiry as capable of dealing fairly with landlords and tenants in a way the present cost pass-through system cannot do. Chapter 6 presents the Inquiry's conclusions and recommendations.

Bases of the Report

The Report rests on two fundamental propositions: first, that private investors and landlords will continue to play the leading part in the residential tenancy market; and second, that because the private market is not satisfactory in some ways and does not meet the needs of all of those who rely on rental housing for shelter, it must be regulated and supplemented.

Role of the Private Sector

Housing requires a large amount of capital investment. The new investment required to replace housing lost through attrition, demolition and conversion to other uses, to conserve existing housing and to meet new demands, is substantial. It is virtually inconceivable that sufficient public funds will be available to satisfy those needs over the next 15 or 20 years. Moreover there are many who argue that private builders and landlords are more efficient than public bodies and make better use of scarce resources. The Inquiry believes that the private sector will continue to be the main supplier of housing.

Regulation and Supplementation of the Private Market

Regulation of the rental housing market must rest on economic principles. Economists did not invent private markets nor is their understanding of market operations always perfect; but economic analysis provides the most coherent explanation of how those markets work. Much of what economists say regarding the operation of markets is couched in professional language not particularly comprehensible — if at all — to the layman. This Report attempts to express the market aspects of its study of rental housing in reasonably understandable terms. There are, however, footnotes to provide technical amplification when the simplified language of the Report itself inadequately expresses economic concepts. John Todd, an economist who was Research Director for the Inquiry, made an essential and invaluable contribution to the economic aspects of the Report and the development of the concepts of fair rent and the Fair Market Rent system of regulation.

The validity of the observation that the housing supplied by the private market must be supplemented by public or socially assisted housing is self evident. The private market must operate at a profit to stay alive and there is a substantial part of the population requiring housing which cannot afford to pay the rents which must be charged if landlords are to remain solvent. Unquestionably, poor and lower income tenants are entitled to decent housing even though they cannot pay for it from their own resources and governments must do for them what the private sector cannot do.

The private market raises problems of a different nature for the approximately two-thirds of the tenant population who can afford to pay market rents. Inherent in the operation of an uncontrolled market is the propensity to sharp and unexpected changes in rent levels and, on occasion, the potential for unconscionable and excessive rent increases. As well there is the question of whether the private market occasionally or consistently allows landlords to make a greater than fair return on their investment. These anomalies are prejudicial to tenants and are a legitimate reason for regulatory intervention. The task is to devise a scheme which protects tenants without interfering unduly with the normal operation of the market to the detriment of the legitimate interests of landlords.

Research Studies

Rental housing is a large and complicated subject which has been reviewed and analyzed in literally scores of studies from many different viewpoints: political, economic, social, regional and so on. It was impossible to give detailed attention to all the available literature with a view to determining its relevance to the problems of rental housing in Ontario. Nor was it feasible to incorporate in the Report itself any adequate presentation of the underlying

theories and principles which bear on the practical matter of regulating and improving the rental housing market. Faced with these constraints, the Inquiry drew on the talents of outstanding students in the relevant fields of interests and commissioned a series of research papers. These papers are listed in Appendix J.

The Inquiry required that these authors be neither landlord nor tenant advocates and that their contribution would not be expressed unduly in the technical language of their profession. The first condition was faithfully observed and the second condition was adequately fulfilled. In their totality the research papers constitute an invaluable contribution to the public understanding of the economic and political aspects of rental housing. Everyone interested in the topic of rental housing will benefit by studying this material.

Chapter 1

The Ontario Rental Housing Market and Rent Regulation

Rents have been regulated in Ontario for more than a decade by a system which has operated in acccordance with the cost pass-through principle. Although the procedures and guidelines have evolved over the years, that underlying principle has not changed, or even been seriously questioned. In Volume 1 of this Report the cost pass-through principle was accepted and consideration was given only to administrative and technical changes which would improve its operation without changing the basic approach.

In this Volume, the more fundamental question of whether rent regulation should be based on a different principle is addressed. The reason for examining alternative regulatory systems[1] which differ in the principles on which they are based is the failure of the current system to maintain a healthy rental housing market in Ontario. This Chapter examines the effect and consequences of Ontario's system of rent regulation and shows that a re-evaluation is needed. The difficulties which have resulted from the past decade of regulation cannot be blamed wholly on administrative or technical failures in implementing the cost pass-through approach. Later chapters show that the cost pass-through principle is not appropriate for a long-term system of rent regulation. As a result, modifying the present system to make it a better cost pass-through system will not eliminate the deleterious consequences.

The Chapter is divided into six sections. Section 1.1 provides a brief overview of the scale and diversity of the Ontario rental housing market. The circumstances which led to the introduction of rent regulation in Ontario and

1. The cost pass-through approach ties the rent increase permitted a residential complex to operating and financing cost increases. Further detail is available on p. 27 in Volume 1 of this Report. See Chapter 3 for a discussion of different types of rent regulation systems, including cost pass-through.

to legislative changes to the system are reviewed in section 1.2. Sections 1.3 and 1.4 examine the effects and consequences of rent regulation in Ontario. Section 1.5 considers other costs of regulation such as the administrative costs for tenants, landlords and government. Section 1.6 briefly examines the distributive impact of rent regulation. It addresses the question of who are the winners and losers. Succeeding chapters of the Report develop the conceptual basis for a system of rent regulation which avoids the pitfalls inherent in the cost pass-through approach and sets rents which are fair and equitable to landlords and tenants in as practicable a manner as possible.

1.1 The Scale and Diversity of the Ontario Rental Housing Market

As of the last Census (1981),[2] 2.4 million of Ontario's total population of 8.6 million were housed in rental accommodation. In terms of households, more than one million of Ontario's three million rented their accommodation. The household demographics of the renter population showed it to be diverse. Forty-four per cent of tenant households were non-family households and 22 per cent were couples without children. The remaining one-third of tenant households had children, with one in three being a lone-parent family.[3] The household head was less than 35 years old in 47 per cent of tenant households and over 65 in 18 per cent.

Ontario's renter households are also diverse in terms of income. At the low end of the scale, 43 per cent of non-family renter households and 21 per cent of family renter households had incomes of less than $10,000 in 1980. At the other end of the spectrum, 12 per cent of non-family and over 30 per cent of family renter households had incomes of $25,000 or more. The average income of renter households, which was $15,000 in 1980, was substantially below the Ontario average household income of $22,600. The lower income is explained by the demographics of renter versus owner households: while 37 per cent of all households were renters, 84 per cent of households were headed by a person under 25, 57 per cent of households were headed by a female, and 50.5 per cent of lone-parent families were renters.[4]

2. The 1981 Census provides the best available indication of the scale and diversity of the tenant population in Ontario. Given the slow rate of change in population demographics, a current profile of the tenant population would be similar to the 1981 profile.

3. See Figure 2 in Appendix A. Families with children include ones where one or both parents live with adult offspring.

4. See Pringle (1986, Table 1.14, p. 37). Also see Statistics Canada, 1981 Census, Catalogue 93-942, Table 38-1.

While it is apparent from the data that problems related to low-income are more prevalent among renters than owners, it is only a minority of tenant households whose incomes are inadequate to allow them to live decently relative to the societal norms of what constitutes an adequate standard of living.

The statistics show that lower income households tend to rent rather than own. However, those low-income households include students who choose to rent an apartment rather than live in residence, as well as lone-parent families struggling to get by. It includes young single people in the early stages of establishing careers, as well as pensioners with little or no savings and handicapped individuals, some of whom may have limited income potential. The tenant population also includes those who might prefer to own but rent because they have insufficient income to buy their own home as well as many financially secure households who choose to rent to avoid the responsibilities of ownership, in some cases because they spend much of the year away.

The kind of accommodation sought by renters is as diverse as their demographics. Some like old buildings with "character", others prefer new high-rises with recreation facilities on the premises. Some place a priority on finding a cheap rent, others seek a convenient location to minimize commuting time or a safe neighbourhood for their children.

The diversity of the demand side of the rental housing market is matched by the diversity of supply. Fully one-third of rental units are in single-unit structures or duplexes. Almost 40 per cent are in apartment buildings with five floors or more. The remaining 27 per cent are in buildings with less than five floors but more than two units. A growing share of the high-rise rental stock consists of condominiums which are rented out, many being owned by individuals who own more than one unit. These owners are small landlords although the units they own may be in high-rise buildings. The City of Toronto Planning and Development Department estimated that as of 1983, 30 per cent of all condominium units in the City of Toronto were rented.

Fully 93 per cent of the rental stock is located in urban areas with a population of 1,000 or more and 74 per cent is in the 10 Census Metropolitan Areas (CMAs)[5] with populations which exceed 100,000.

A significant portion, 12.7 per cent, of the rental stock was socially assisted housing at the time of the 1981 Census and the portion has been growing steadily since that time. More than half of the socially assisted housing (6.9 per cent) was public housing, with most of the rest being limited dividend units[6] (2.4 per cent) and non-profit and co-operative housing (2.3 per cent).

5. The 10 CMAs are Hamilton, Kitchener, London, Oshawa, Ottawa, St. Catharines-Niagara, Sudbury, Thunder Bay, Toronto and Windsor.

6. Started in 1938 but used only significantly since 1967, the Limited Dividend Housing Program

Socially assisted housing accounted for about 20 per cent of the net additions to Ontario's rental stock during the 1966-71 and the 1976-81 periods. Almost 38 per cent of the net additions were socially assisted housing during the 1971-76 period. In 1985 they comprised an estimated 40 per cent of net additions.

1.2 The Genesis of Rent Regulation in Ontario

The Ontario cost pass-through system of rent regulation was introduced at a time when inflation was a major public concern. In the two years preceding the introduction of the system late in 1975, the annual rates of increase in the Consumer Price Index (CPI) were 10.9 per cent and 10.8 per cent. The inflation rate was significantly higher than had been experienced in Ontario up to that time.

Shortly before the introduction of rent regulation in Ontario, the federal government had introduced its Anti-Inflation Program[7] and asked the provinces to undertake rent regulation as a temporary measure to fight inflation in the Canadian economy. What was produced in Ontario in 1975 was an across-the-board rent increase ceiling of eight per cent (subject to larger rent review increases) which was almost three percentage points below the 1975 inflation rate.

After inflation abated in 1976 and 1977 so that the rate of increase in the CPI fell below the statutory rate for rent increases, the rate was reduced to six per cent commencing in 1978. Although inflation climbed steadily for the next four years, peaking at 12.5 per cent in 1981, the six per cent statutory rate was not adjusted upward. As of August 1, 1985, with inflation declining to less than six per cent per annum from 1983 onward, the statutory rate was reduced to four per cent which kept it below the rate of increase in the CPI. Commencing in 1987, the rate will be determined annually in accordance with a statutory formula calculated by the government. For 1987, the rate was set at 5.2 per cent which is above the 1986 inflation rate of 4.1 per cent per annum.

Although one of the original purposes of rent regulation in Ontario may have been to fight inflation, it is evident it does not serve that purpose at the present time. Even before the federal government's anti-inflation initiative,

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was designed to promote the development of moderately priced rental accommodation. Canada Mortgage and Housing Corporation (CMHC) offered loans up to 95 per cent, at below market rates of interest, of the capital costs of a rental construction or improvement project. In return, builders agreed to allow CMHC to control rents and increases which gave owners an acceptable rate on return on their investment but also kept the units affordable to low income tenants. After 15 years, if the loan was repaid, owners could opt out of the agreement. There has been no activity in this program since 1981.

7. Stanbury and Thain (1986) review the events leading up to the introduction of rent regulation in Ontario in 1975.

there was a great deal of political pressure to introduce rent regulation to curb gouging which was the popular catch-all word used to describe rent increases regarded as unconscionable or excessive.[8] Had the system which emerged been directed specifically to controlling an indefensible even if not clearly defined practice, it could have been of a less stringent design, with the guideline rate equal to or greater than the rate of increase in the CPI. Even that might have allowed less than normal market rents since rent increases prior to 1975 had been lagging behind increases in consumer prices generally. Large catch-up increases were feared by many tenants, particularly those who had had multi-year leases. Inadvertently or otherwise the scheme appears to have had the effect of protecting the gains made by tenants due to the lag between the escalation of rents and the increase in the inflation rate generally.

As a temporary measure for fighting inflation the Ontario scheme of rent regulation did not take into account the landlord's return on equity although it was adequate to ensure that landlords' cash flow was sufficient to cover out-of-pocket operating and financing costs. Whatever its effect on investment returns, a short-term regulatory system would have little impact on rental housing supply given the long time periods and high capital cost of either entering or exiting the industry. However, in the long-run, an adequate return on investment is essential to attract sufficient investment to maintain and conserve the existing stock and to finance enough new rental housing to maintain a reasonable vacancy rate. Prior to the 1986 Act, the Ontario system did not recognize landlords' return on equity when setting rents.[9] The end result, therefore, is that any impact the system has on the return earned by landlords occurs incidentally through the mechanics of the system, rather than by a calculated determination of what is required.

Reasons for the position taken by government officials who implemented the cost pass-through concept of rent regulation, established in the 1975 legislation, are set out in section 9.4 of Volume 1 of the Report commencing at p. 110. There are features of the Ontario regulatory system which in some circumstances have had the effect of increasing the landlords' return on equity, namely, the allowance of principal payments on mortgage debt as a cost which can be passed-through as a rent increase[10] the absence of a mechanism to

8. Chapter 4 identifies several distinct problems often referred to as gouging. The "indefensible" practice referred to in this paragraph is called excessive rent charges in section 4.2.

9. Under the 1986 Act, return on equity is considered only for buildings not rented prior to 1976 and suffering an "economic loss". See section 80 of the 1986 Act. Section 3.1.3.2 of this Report discusses systems of rent regulation which take into account the landlords' return on equity.

10. The pass-through of principal payments has been restricted in two ways. First, since 1975, mortgages allowed for rent review purposes could not exceed 85 per cent of the purchase cost

remove costs no longer borne; and a statutory rate of increase which on occasion may have enabled some landlords to increase rents by more than their costs had increased.

With regard to the pass-through of principal payments it was said in Volume 1 of the Report:

> To permit landlords to raise rents by passing-through albeit in a restricted manner, some part of the principal payments incurred in the purchase of the property is an unsatisfactory way of allowing landlords to make a return on their original investment. It cannot be known in advance whether in any particular case it works to the benefit of the landlord or the tenant, because it is not known whether it assures the landlord of more or less than a fair return on his investment in the property during the time he holds it. That cannot be ascertained without determining the net effect of all the relevant factors on the return earned by the landlord on either the original purchase price or some alternative measure of his equity base. (p. 113)

The problem is that the cost pass-through factors have an effect which is not linked to the adequacy of the return on investment. The result may be far too generous or conversely so inadequate as to make investment in rental housing unattractive. One trend has been clear, however. The "loopholes" which provided the opportunity for landlords to earn a return on equity have been constantly under attack since they have no intrinsic merit within a system of rent regulation. As a consequence, the system has evolved over the years through changes in the guidelines and relevant legislation, to eliminate those indirect means of maintaining the landlords return on equity. To a certain extent that trend has continued in the 1986 Act but an economic loss provision has been introduced for post-1975 buildings which, for the first time, explicitly provides for a return on equity partially to provide an appropriate return. It is

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of the property. Second, principal payments have been notionalized where necessary so that they were not greater than would be paid on a normal blended payment mortgage amortized over a 20-year period. Third, since the introduction of the 1982 Interim Act, the size of the rent increase attributable to a financial loss has been restricted by section 3 of that Act. All of these restrictions have been carried into the revised system governed by the 1986 Act. A crucial consideration is that increased financing costs due to an increase in mortgage principal can only be used for rent review purposes if the increased financing resulted from the sale and purchase of the property. As a consequence, the benefit of being able to take principal payments on account of mortgage debt into consideration in the determination of rent increases could be enjoyed only by purchasers who incurred new debt. The continuing landlords were locked into their historic cash flow positions, whatever it might have been meant for their return on investment, with no chance of relief.

too early to determine whether the overall effect will be to induce private investment to renew its interest in the industry.

1.3 The Effect Of Rent Regulation

It can be said that rent regulation's only direct effect is to reduce the rents tenants pay. A number of consequences follow from that direct effect which are discussed below in section 1.4.

The effect on rents can be considered both in terms of the average rent increase and in terms of the variation among individual rent increases. Even if an increase in the overall rent level is modest, severe hardship can occur for those tenants who occupy units which suffer large increases — particularly if they are faced with either paying the steep increase or vacating their units. The effect of Ontario's rent regulation system is considered from each of these perspectives below.

1.3.1 Reduced Average Rents

The effect of rent regulation in Ontario has been to lower rent levels for controlled apartments and thus reduce the amount of rent the tenants otherwise would have paid their landlords. The amount by which it has held rents down is difficult to determine, however. Table 1 shows various indices which can be used as indicators which provide reference points for assessing the impact of rent increases since 1975. For the 1975 to 1985 period, the CPI rent index was 5.98 per cent which was below the rate of increase in the CPI, all items (8.08 per cent) and the statutory rate of increase which was equivalent to a constant annual rate of 6.4 per cent. It should be noted that the rate of increase in the CPI rent index has been below the rate of increase in the CPI all items historically. The ratio of the rates of increase in the rent index and all items was 0.74 over the 1975 to 1985 period, but it was 0.69 over the 1950 to 1975 period. It also may be noted that in the 1975 to 1985 period both the rent index (5.98 per cent) and the guideline rate (6.4 per cent) were less than either the wage index (7.31 per cent) or the renter income index (8.13 per cent). It is evident that renters have come to expect rents to become cheaper relative to both income and other goods and services they buy. If rents had just kept pace with inflation from 1975 through 1986, they now would be more than 20 per cent higher than they are currently. The Residential Complex Cost Index (RCCI) and the Building Operating Cost Index (BOCI) as set out in the 1986 Act and Regulations can be used as indicators of the rate of increase in landlords costs and, hence of the rent increases that would have been required for them to stay abreast of their expenses. The Inquiry calculated what these indices would have been for the years 1975 through 1985 based on the formulae set out in the Schedules to the 1986 Act. It appears that the BOCI and RCCI had

TABLE 1: Affordability Indexes, Annual Percentage Change, 1971-19861

	CPI All items (1)	Rent Index (2)	Current Guideline (3)	Building Operating Cost Index (4)	Complex Cost Index (5)	Wage Index (6)	Renter Income Index (7)	Ratio of Increases to CPI (2/1)	(3/1)	(4/1)	(5/1)	(6/1)	(7/1)
1971	2.9	1.6	—	—	—	9.9	9.9	0.5	—	—	—	3.4	3.4
1972	4.7	1.2	—	3.8	—	6.2	6.1	0.3	—	0.8	—	1.3	1.3
1973	7.7	1.4	—	5.6	—	6.6	6.1	0.2	—	0.7	—	0.9	0.8
1974	10.9	2.7	—	7.4	—	12.1	9.4	0.2	—	0.7	—	1.1	0.9
1975	10.8	5.4	8.0	9.5	5.7	13.2	9.4	0.5	0.7	0.9	0.5	1.2	0.9
1976	7.5	7.0	8.0	13.5	7.0	10.7	11.0	0.9	1.1	1.8	0.9	1.4	1.5
1977	7.9	6.2	8.0	11.5	8.8	8.1	11.0	0.8	1.0	1.4	1.1	1.0	1.4
1978	8.8	5.3	6.0	9.4	9.7	5.6	7.7	0.6	0.7	1.1	1.1	0.6	0.9
1979	9.2	4.4	6.0	7.6	9.7	8.0	7.7	0.5	0.7	0.8	1.1	0.9	0.8
1980	10.2	4.8	6.0	7.5	8.3	10.3	11.9	0.5	0.6	0.7	0.8	1.9	1.2
1981	12.5	6.4	6.0	12.2	7.5	11.4	11.9	0.5	0.5	1.0	0.6	0.9	1.0
1982	10.8	9.0	6.0	13.1	8.1	9.5	3.8	0.8	0.6	1.2	0.7	0.9	0.4
1983	5.8	7.5	6.0	8.0	9.3	0.5	6.0	1.3	1.0	1.4	1.6	0.1	1.0
1984	4.4	5.0	6.0	4.9	9.4	4.7	6.0	1.2	1.4	1.1	2.2	1.1	1.4
1985	4.0	4.2	6.0	4.9	7.8	4.7	4.7	1.1	1.5	1.2	1.9	1.2	1.2
1986	4.1	4.1	4.0	1.9	5.9	3.4	3.4	1.0	1.0	0.5	1.5	0.8	0.8
	Average Compound Rate of Increase, 1975-1985							Ratio of Average Increase					
	8.08%	5.98%	6.40%	9.23%	8.54%	7.31%	8.13%	0.74	0.79	1.14	1.06	0.90	1.01

NOTES: 1. The indexes (1981 = 100) include: CPI: Consumer Price index, all items, Canada; Rent index: from CPI data, Canada; Current Guideline index: Ontario's statutory guideline increase; Building Operating Cost index (BOCI) and Residential Complex Cost index (RCCI): constructed following the 1986 Act and Regulations. The CPI homeowner's property tax component was used in place of data from 'municipal financial statements' when calculating the municipal tax component. The increase in the RCCI in any given year equals 2.0 per cent plus 2/3 the value of BOCI where the latter is a three-year moving average to the end of the previous year. For example, the 1975 increase in RCCI of 5.71 per cent equals 2.0 per cent plus two-thirds the average of BOCI for the years 1972-1974. These calculations of BOCI/RCCI, by the Inquiry's staff, are for illustrative purposes only and are not meant to be official in any way; Wage Index: constructed from average weekly wages industrial aggregate for Ontario; Renter Income index: constructed from renter household income (Ontario) data from the Household Income, Facilities and Equipment surveys. For 1971 and 1985 the increases over 1970 and 1984 were derived from the increase in average weekly wages.

SOURCES: Derived from Statistics Canada, Cat. 13-567, 62-010, 72-002 and from the *Residential Rent Regulation Act, 1986* and R.O.C 469/86.

increased by amounts that are equivalent to 9.23 per cent and 8.54 per cent annual increases, respectively. Hence, if rents had risen at the same rate as the BOCI in the absence of rent regulation, they would now be more than 33 per cent higher than they actually are. If rents had risen at the same rate as the RCCI they would now be 30 per cent higher.

Researchers have used other methods for estimating the effects of rent regulation on rents. Slack (1986)[11] examines the magnitude of those effects and concludes:

> . . . the costs to landlords of controlled units in terms of lost rental income is somewhere between 7.5 and 11 per cent of gross rents. . . . As noted above those are offset by gains to tenants in the controlled sector and . . . thus are transfers rather than economic costs. (p. 20)

The conclusion in the Slack study translated into dollars is expressed as follows:

> In terms of the transfer, the loss in rental income to landlords is estimated to be between $259.3 million and $377.3 million (1984). (pp. 22-23)

That is a substantial sum of money. To put it another way, using the median amount of $318-million, it would average a monthly gain for the 850,000 tenant households in controlled rental housing in Ontario of about $31 a month.[12] The average, however, is not indicative of the actual benefit received by individual tenant households. The next section addresses that issue.

The benefits of rent regulation enjoyed by tenants in controlled units explains the vigor with which their advocates press for continuation of the existing restrictions.

The variation among landlords, who range from individuals holding one or two units to multi-million dollar corporations holding thousands of units, is so great that any similar per capita calculation would be meaningless. It is

11. The study, which was commissioned by the Inquiry:
> . . . relies heavily on other work done for the Commission as well as the broader literature on rent regulation. It is intended to bring together the analysis from these different sources and summarize the result. (p. 1)

12. The annual loss of rental income appears to be increasing each year. Based on revised rent data collected by the CMHC survey since 1982 in which the controlled and uncontrolled sectors are dealt with separately, Stanbury and Vertinsky (1986) observe that, "it appears that rent controls reduced the rate of increase by between three and seven percentage points" in the Toronto CMA for the years 1982-1984. (pp. 6-7)

obvious however that a gross loss of revenue in the order of several hundred million dollars annually, extending for a period of more than a decade, must have an appreciable effect on the attitudes and behaviour of investors and landlords.

1.3.2 Variation In Rent Increases for Individual Units

Rent regulation as introduced in 1975 had a twofold purpose. As noted above it was intended as an anti-inflation measure to keep rents from increasing as fast as they might otherwise have. Rent increases were to be limited to actual increases in operating and financing costs. The effect proved to be restrictive and rents in the regulated market overall were held below market levels. The other purpose, which was given the greater publicity, was to protect tenants against sudden sharp rent increases alleged to be a frequent occurrence in the unregulated marketplace.

In theory, rent increases which exceeded the rate of cost increases should not have been possible following the 1975 introduction of rent regulation. Whether landlords took the statutory increase or applied for a cost pass-through in a rent review hearing, it was conceived that the annual increase would be constrained and tenants would be protected against unjustified sudden rent increases. As a consequence, rent regulation would contribute to tenants' peace of mind and a greater feeling of security, particularly for those who were approaching or had reached the limit of what they could afford.

Two important issues arise in considering the actual situation which developed regarding rent increases for individual units. First, in some circumstances rent increases might be less than the statutory rate. Increases in this range could be considered not to have been affected by rent regulation. Second, there was the risk under the rent review mechanism that rent increases experienced by some tenants would be large relative to average increases in the market and to those increases which would have occurred in the absence of rent regulation. An examination of the record leads to the opinion that the net effect of the regulatory system on the risk of large increases is not clear.

Stanbury and Vertinsky (1986) address the first issue by analyzing data for the 1977 to 1981 period.[13] They observe that:

> . . . a substantial fraction (about one-third) of tenants did not experience an increase in rent when (i) vacancy rates were low or very

13. Ministry of Municipal Affairs and Housing (MMAH), *Rental Housing Survey*, various years. (Note that the Ministry of Housing became the Ministry of Municipal Affairs and Housing in July, 1981, and is now once again the Ministry of Housing). See also Stanbury and Vertinsky (1986) Tables 6-42, 6-43 and 6-44.

> low, (ii) the legally allowable increase without rent review was 6%, and (iii) the general rate of inflation was between 8% and 12%. (pp. 6-131 to 6-135)

It might be assumed that those tenants who experienced increases below the statutory rate would not have experienced larger rent increases in the absence of rent regulation. However, both landlord and tenant advocates support the view that, in practice, the existence of a legislated statutory limit is an inducement for some landlords to raise their rents annually by that amount.[14] Hence, rent increases below the statutory rate are less frequent than they would have been had there been no rent regulation.[15]

It is evident that those tenants who would have been most likely to experience a small, or nil, rent increase get the least benefit from rent regulation. Stanbury and Vertinsky (1986) give some insight into who those tenants are:

> . . . while the turnover of tenants in smaller buildings is no lower than it is in larger ones, tenants in small buildings who do not move are rewarded with lower increases in rent. Between 1977 and 1981 a much higher fraction of non-movers in smaller buildings didn't have any increase in their rent as compared with those in larger buildings . . .
>
> Do movers experience higher increases in rent in the year they move? The data in Table 6-44 suggest that, on average, they do. (p. 6-135)

The fact that movers faced larger rent increases than non-movers should be interpreted with care. As Stanbury and Vertinsky (1986) state:

> . . . the observed difference in the average rent increases of movers and non-movers may be attributable to differences in quality, that is, movers moved into units that were higher quality than their previous unit. It may have been newer, larger, and contained more amenities. Recall from Table 6-39 [(Stanbury and Vertinsky (1986, p. 6-125)] that almost one-quarter of movers said they moved because of the "physical properties of the unit". (p. 6-136)

14. See the study by, M. Walker (1975, in *Rent Control: A Popular Paradox, Evidence on the Economic Effects of Rent Control*, pp. 53-56) and the testimony of J. Miron in Transcript 66, pp. 27-28.

15. This effect is in addition to the effect that the tightening of rental markets may have on the frequency of small rent increases.

With regard to the second issue, that the review mechanism carries the risk that the rents for some individual units may increase substantially, in practice rent review in Ontario indeed has not always protected tenants from large rent increases. They may enjoy low increases for several years when their landlords take only the guideline increase, but when landlords do apply to rent review, the increases allowed have often been substantially larger than the statutory rate.

Tables 2 and 3 summarize the distribution of rent increases allowed by the Commission. In the seven years for which the Commission has reported the distribution of percentage increases on a per building basis, between seven and 22 per cent of all buildings reviewed were granted aggregate increases in excess of 25 per cent. In three of the last five years the proportion of reviewed buildings granted increases in excess of 50 per cent, was more than two per cent. In two of those years, fiscal 1981-82 and 1982-83, roughly half of all buildings reviewed were granted increases in excess of 16 per cent.

The proportion of units for which the increases granted exceeded 25 per cent was consistently less than the proportion of buildings granted the same increases, indicating that smaller buildings tended to be granted large increases more frequently than large buildings. Nevertheless, in 1979, 4.74 per cent of all units reviewed received increases in excess of 25 per cent. In the following four fiscal years, the data are not reported on a unit basis, but since the number of buildings granted large increases almost doubled from 1979 to the 1981-83 period, it is reasonable to assume that the number of units receiving increases in excess of 25 per cent approached 10 per cent of all units subject to rent review decisions. Since between 10 and 15 per cent of the total pre-1975 stock was reviewed in the 1981-82 and 1982-83 reporting years, respectively, it appears that something in excess of one per cent of the total controlled stock or more than 10,000 units experienced increases in excess of 25 per cent in the years when inflation was highest.

There is no way of knowing how frequent large rent increases would have been in the absence of regulation. However, whether or not the frequency was reduced by regulation, it is evident that tenants have not been protected from large increases. No conclusion can be drawn as to whether the resulting rents were in line with the market — i.e. the increase was necessary because the rent had been artifically depressed — or whether landlords were permitted to charge rents which were high relative to the rents which would have prevailed if the market were not regulated.

1.4 The Consequences Of Rent Reductions

There are many consequences of the reduction in rental payments. Some affect only landlords, others both landlords and tenants but in different ways, and

TABLE 2(A): Distribution of Buildings by Percentage Increase Granted

Year	<=10%	10-12%	12-14%	14-16%	16-20%	20-25%	>25%	25-30%	30-35%	35-40%	40-50%	>50%	Total
1979-80[1]	209	102	79	52	59	44	68						613
1980-81	448	201	159	128	169	119	214						1,438
1981-82	491	352	283	289	426	313	597						2,751
1982-83	750	484	422	431	643	571	901	206	134	88	80	89	4,202
1983-84	1,063	434	312	250	278	188	217	335	202	140	124	100	2,742
1984-85	568	204	147	129	162	87	102	87	59	25	23	23	1,399
1985-86	661	238	133	107	115	73	141	39	16	10	17	20	1,468
								59	24	17	11	30	

NOTE: The percentage increase was not reported on a building basis prior to the 1979-80 fiscal year.

1. The 1979-80 data are for the six month period from September 1979 to March 31, 1980. All subsequent fiscal years are for the 12 month period April 1 to March 31 the following year.

SOURCE: Residential Tenancy Commission, *Report to the Minister*, annual.

TABLE 2(B): Range of Percentage Increase in Revenue Granted for all Buildings by Hearings

Year	<=10%	10-12%	12-14%	14-16%	16-20%	20-25%	>25%	25-30%	30-35%	35-40%	40-50%	>50%
1976	34.09	16.64	12.89	8.48	9.62	7.18	11.09					
1977	31.15	13.98	11.06	8.90	11.75	8.28	14.88					
1978	17.85	12.80	10.29	10.51	15.49	11.38	21.70	7.49	4.87	3.20	2.91	3.24
1979	17.85	11.52	10.04	10.26	15.30	13.59	21.44	7.97	4.81	3.33	2.95	2.38
1983-84	38.77	15.83	11.38	9.12	10.14	6.86	7.91	3.17	2.15	.91	.84	.84
1984-85	40.60	14.58	10.51	9.22	11.58	6.22	7.29	2.79	1.14	.71	1.22	1.43
1985-86	45.03	16.21	9.06	7.29	7.83	4.97	9.60	4.02	1.63	1.16	.75	2.04

NOTE: The percentage increase was not reported on a unit basis for the 1979-80 through 1982-83 fiscal years.

1. The 1979 data are for the applications made under The Residential Premises Rent Review Act. Applications were accepted only until September 1979 for increases taking effect before December 1, 1979. Pertaining to increases effective on December 1, 1979 or later were subject to The Residential Tenancies Act.

SOURCE: Residential Tenancy Commission, *Report to the Minister*, annual.

TABLE 3(A): Distribution of Units by Percentage Increase Granted

Year	<=10%	10-12%	12-14%	14-16%	16-20%	20-25%	>25%	25-30%	30-35%	35-40%	40-50%	>50%	Total
1976	44,889	28,390	21,191	14,576	14,486	4,357	3,566						131,455
1977	15,308	7,942	5,282	3,919	3,468	1,838	1,462						39,219
1978	27,299	6,164	2,374	1,585	2,127	892	508						40,949
1979	11,066	2,486	1,532	721	1,279	415	871						18,370
1983-84	60,142	17,070	9,696	6,964	5,913	4,497	2,190	1,191	391	25	139	244	106,472
1984-85	31,795	9,241	4,748	4,186	2,749	536	531	27	98	44	95	67	53,786
1985-86	32,887	11,533	4,709	2,312	1,634	964	847	459	152	79	56	101	54,886

NOTE: The percentage increase was not reported on a unit basis for the 1979-80 through 1982-83 fiscal years.

1. The 1979 data are for the applications made under The Residential Premises Rent Review Act. Applications were accepted only until September 1979 for increases taking effect before December 1, 1979. Applications pertaining to increases effective on December 1, 1979 or later were subject to The Residential Tenancies Act.

SOURCE: Residential Tenancy Commission, *Report to the Minister*, annual.

TABLE 3(B): Range of Percentage Increase in Revenue Granted for all Units by Hearings

Year	<=10%	10-12%	12-14%	14-16%	16-20%	20-25%	>25%	25-30%	30-35%	35-40%	40-50%	>50%
1979-80[1]	34.15	21.60	16.12	11.09	11.02	3.31	2.71					
1980-81	39.03	20.25	13.47	9.99	8.84	4.69	3.73					
1981-82	66.67	15.05	5.80	3.87	5.19	2.18	1.24					
1982-83	60.24	13.53	8.34	3.92	6.96	2.26	4.74					
1983-84	56.49	16.03	9.11	6.54	5.55	4.22	2.06	1.12	.37	.02	.13	.23
1984-85	59.11	17.18	8.83	7.78	5.11	1.00	.99	.05	.18	.08	.18	.12
1985-86	59.92	21.01	8.58	4.21	2.98	1.76	1.54	.84	.28	14	.10	.18

NOTE: The percentage increase was not reported on a building basis prior to the 1979-80 fiscal year.

1. The 1979-80 data are for the six month period from September 1979 to March 31, 1980. All subsequent fiscal years are for the 12 month period April 1 to March 31 the following year.

SOURCE: Residential Tenancy Commission, *Report to the Minister*, annual.

still others affect the whole community. The benefit to landlords is minimal and although the consequences mainly are beneficial to tenants, some are prejudicial to them as well.

1.4.1 Housing More Affordable by Some

As a consequence of rents being held down, one would expect that the burden of the affordability problem would be eased.[16] However the important questions to answer are which renter households can afford their housing more easily and how much of a benefit they are receiving in the form of reduced rents.

The recipients of reduced rents are those tenant households occupying controlled units. Thus, in terms of affordability, rent regulation is not directed specifically to those in need. The region of Peel, Department of Housing, said in a 1985 submission to the Inquiry:

> Rent review is not targetted to the needy. It has not helped those unable to find a unit subject to rent review and it has not provided sufficient help to households with low incomes. It has, however, served households who required no help at all. Higher income households have remained in units subject to rent review, while the needy have been forced to seek shelter in the exempt stock which is more expensive. (Exhibit #135, p. 20)

These anomolies have received attention in a number of studies.[17] Among them, Stanbury and Vertinsky (1986) focus on the disparity in benefits among tenant households in Ontario in 1981 by reference to household incomes. Using data derived from the 1981 Census, the authors worked out the average rents by household incomes for the period before 1976 and between 1976 and 1981. From this they developed a table showing rents in the controlled sector and the uncontrolled sector for households in various income levels.[18] The conclusions in Stanbury and Vertinsky (1986) are:

16. Section 4.1.1 and Appendix C discuss the measurement of affordability problems and estimates of their magnitude in Ontario. This section addresses the question of how rent regulation has changed the affordability of rental housing for renter households.

17. For example, see Blatt (1982), Fallis and Smith (1985), Marks (1984), MMAH (1982, Chs. 6 and 7), Miron and Cullingworth (1983), Steele and Miron (1984), and Stanbury and Vertinsky (1986). The latter study also provides a review of a number of the other studies. See, also, section 1.4.7 of this Report.

18. See Tables 6-35 and 6-36 in Stanbury and Vertinsky (1986).

(i) For tenants living in rent controlled units 83.5% of the total benefits [of rent reduction] went to the 56% of tenant households with an annual income *above* $15,000 in 1981. The 44% of tenants with incomes under $15,000 received only 16.5% of the total benefits. The 24% of tenants with a household income above $25,000 received 38.4% of the total pecuniary benefits — an average of $432 per household per year. In contrast, households below $15,000 received only about $102 per year in benefits in the form of a rent below the equilibrium level.[19]

(ii) The distinctly non-poor, namely the 38.6% of tenant households in the controlled sector with incomes above $20,000 received 60% of the pecuniary benefits of rent control in 1981.

(iii) While tenants in the controlled sector received some $228 million in rent control benefits, those in the uncontrolled sector (but not living in social housing) paid some $34 million in *higher* rents because of rent control. Some 77% of the total higher rent payments were made by the 72% of households in the uncontrolled sector with an income above $20,000 in 1981.

(iv) While households with an income below $20,000 (recall the average in 1981 was $17,600) in the controlled sector received some $91 million in pecuniary benefits, those in the uncontrolled sector paid *higher* rents amounting to about $8 million in 1981. (p. 6-112)

After analyzing another study of the benefits of rent regulation Stanbury and Vertinsky (1986) state:

> Therefore, both studies conclude that the bulk of the gross and net pecuniary benefits go to tenant households which have incomes well above the poor to moderate level and which have no affordability problem. This fact helps to explain why controls are established in the first place and why they persist. The bulk of the saving in the form of lower-than-market rents go to the majority of households that are *not* poor. (pp. 6-113 to 6-114. Emphasis in original)

Certain types of tenants may be more likely to reside in units with the largest rent reductions. It is clear that landlords utilize various criteria, other than willingness to pay, for choosing tenants when rent regulation holds their rents down and waiting lists develop for the most attractively priced units.

19. The equilibrium level is the rent level which would prevailed if there were no rent regulation.

Available studies suggest landlords will choose the least costly tenants — those likely to stay for a long time and those who are responsible and trouble-free. One way to measure a tenant's reliability is by income, on the assumption that higher-income people make better tenants (Arnott, 1981). In such a situation, the poor are likely to be disproportionately the losers if only because their poverty makes them less creditworthy than high income tenants (Steele and Miron, 1984, p. 52). They will have to pay the higher rents in the exempt sector. Slack and Amborski (1984) suggest that landlords may tend to favor single person households over families with children on the assumption that the former group will be less troublesome (p. 8).[20]

The Region of Peel, Department of Housing comments:

> Almost three quarters of tenant households in Peel Region during 1981 paid less than 30% of their income to rent and did not require any housing assistance. On the other hand, 16% were having severe affordability problems even with rent review . . .
>
> Rent review has had an enormous impact on rents in Peel Region by creating a huge gap in rent between units subject to and not subject to rent review. . . . As of 1984, this gap was as much as $170 depending on unit size. The Region of Peel has monitored this gap and found that in 1980 it was about $50, while in 1982 it has grown to $80. This widening gap has played havoc with the rental market. The market for pre-1976 rental units is very tight as vacant units are almost non-existent and turnover is very low. In the post-1976 rental units, particularly those built since 1982, private landlords are faced with higher vacancy and turnover rates.
>
> Because rent review is responsible for this widening gap, those who are lucky to have a controlled unit will benefit regardless of their income. Also, there is no reason for higher income tenants to leave these units and make way for low income tenants. The low income tenants will experience severe affordability problems if only exempt units are available to them. (pp. 20-21)

For the foregoing reasons, the overall impact of rent regulation may benefit low-income tenants even less than suggested by Stanbury and Vertinsky (1986). The likely beneficiaries of rent regulation are probably long-term tenants or

20. The person who controls access to rent regulated units may also charge side payments when the unit changes hands. That issue is discussed below in section 1.4.6.

least costly households in large,[21] pre-1976 multiple-unit buildings. Many of the tenants who benefit may be among the elderly, who are fairly immobile and relatively low cost. As well, many middle-income and some upper-income tenants also would tend to benefit. On the other hand, low-income families, lone parents and young singles would be less likely to realize the benefits of rent regulation since they would be seen by many landlords as relatively high cost, and therefore undesirable, tenants.

1.4.2 Reduced Return on Investment and Capital Value

The evidence pertaining to the return earned by investors in rental housing is surveyed in Appendix E. It shows that, in the absence of rent regulation, investors in rental housing earn returns on average which are at most a few percentage points above those earned on alternative investments involving similar risk. The conclusion drawn from theoretical analysis that in an unregulated market excess returns are not sustainable is consistent with the available empirical evidences. As Appendix D shows, the indicators of competitiveness demonstrate that the rental housing market is quite competitive by Canadian standards.

It follows that if the Ontario system of rent regulation has reduced rents significantly — and the range of the estimated effect on rents of 7.5 to 11 per cent is significant — the return earned by investors in the regulated sector of the private housing market on average is less than the return being earned on alternative investments involving similar risk. Even if landlords would have earned excess profits if rent regulation had not been introduced in 1975, the evidence presented in Appendix E shows that the estimated reduction in the average rent level due to rent regulation in Ontario is several times greater than that necessary to eliminate any excess profits which might have been earned.[22]

A reduction in the earnings of landlords is necessarily accompanied by a decline in the value of their properties. Property values are determined on the basis of expected future earnings; hence, for each percentage point that rent regulation reduces future net income, property values should decline by one percentage point as well. Forces which may maintain property values while rent regulation depresses income are: 1. property owners and buyers may anticipate that rent regulation will be relaxed in the future; 2. property owners and buyers may anticipate that the sale and purchase of the property will lead

21. It seems a reasonable assumption that the landlords of large buildings find it more difficult than the landlords of small buildings to increase rents illegally between tenancies (Steele and Miron, 1984, p. 62).

22. The issue of excess profits is examined more fully in section 4.3.

to rent increases which eventually will increase net income, for example, by the pass-through of a financial loss; or 3. property owners and buyers may anticipate converting the property to another use in which rent regulation will not affect the income of the property.[23]

The link between the effect of rent regulation on rents and the consequences discussed in the balance of this Chapter is the depressed return on the investment of landlords of pre-1975 buildings and the consequent perceived risk for post-1975 investment which, even when exempt, was seen to be vulnerable to being brought within the regulatory system. This in fact has now happened.

The consequences of an inadequate return on investment in rental housing are not only harmful for landlords, but also can be prejudicial to tenants. The disadvantages affect different tenants in different ways. For on-going tenants there are such matters as the quality of their accommodation diminishing as the landlord cuts costs to compensate for reduced rents as well as the restricted supply of regulated units at reduced rents which locks some tenants into accommodation no longer satisfactory. For middle and lower income families who are searching for suitable rental housing, the low vacancy rate which is a feature of rent regulation, imposes additional strains and costs. The sustained pressure from tenant advocates might indicate that, generally speaking, the prospect of continuing with less than normal rents outweighs any accompanying inconveniences or indirect costs. However, it is becoming increasingly apparent that the consequences of holding rents down for an extended period of time can be harmful to tenants in general, particularly to tenants in the future.

With regard to landlords, and here also it will be appreciated that landlords are affected differently, the general picture is that because of rent regulation, their current income is inadequate and the value of their properties has not appreciated in line with the value of other forms of property. The paradox of rent regulation, however, is that it has enabled landlords in particular situations to increase rents and take advantage of the opportunitiy to earn a high return afforded by the shortage of rental housing.

1.4.3 Reduction in New Supply of Rental Housing

It is apparent that the decline in the rate of return which can be expected on investment in rental housing will reduce the supply of unsubsidized private sector rental housing. New construction requires investment and investment must be attracted by the prospect of a competitive rate of return. Many factors

23. Restrictions on the freedom of landlords to convert their properties to other uses will tend to reduce property values so that they fully reflect the effect of rent regulation on net rental income.

may affect the return investors anticipate from investment in rental housing. To the extent that rent regulation changes the rents developers of properties anticipate being able to collect, their willingness to invest will be affected. Rent regulation affected the anticipated rents for new buildings even when they were not controlled in two ways. First, by holding down current rents, tenants have not moved from controlled accommodation and few have been willing to pay the higher rent necessary to make new buildings economical. Second, potential investors recognized the possibility that the rules of rent regulation might change and their future rents might be held down. With the introduction of the 1986 Act, this possibility has become a reality.

The extent to which the curtailment of new construction is attributable to rent regulation is difficult to measure precisely. The topic is given extended consideration by Stanbury and Vertinsky (1986). The discussion is introduced as follows:

> While most economists argue/conclude that, on balance, rent controls will reduce the future supply of rental units, the matter as seen by policy makers is largely an *empirical* one. What evidence do we have to indicate that rent controls have ''caused'' a reduction in the supply of new units since 1975 when they were enacted? (p. 29)

As background for the discussion the authors produced Table 4 (Table 6-20 in Stanbury and Vertinsky 1986 p. 6-72) showing Ontario private housing starts by categories for 1969-1984.

The figures up to 1979 in the right hand column of non-government and government-assisted starts are taken from data compiled by Smith and Tomlinson in a 1981 paper entitled *Rent Controls in Ontario: Roofs or Ceilings*? The text of the paper indicates that non-government assisted starts is equated with the purely private or unsubsidized sector of the market. Current information acquired from CMHC provides the data with regard to private unsubsidized starts since 1979.

Stanbury and Vertinsky (1986) conclude:

> It is clear that the composition of new rental starts in Ontario has shifted dramatically since rent controls were imposed in December 1975. Smith and Tomlinson (1981, p. 98) indicate that in the six years prior to controls private, unsubsidized rental starts accounted for 72.2% of all rental starts. From 1975 to 1980 the ratio fell to 37.8%. MOMAH (1983, p. i) states that between 1976 and 1981 'direct government subsidies were a factor in 75 percent of the 80,000 new [rental] units constructed'.

TABLE 4: Ontario Housing Starts by Categories, 1969–1984

Year	Total Row and Apartment Starts	Total Condo. and Rental Apt. Starts	Total Condo. Starts	Total Rental Starts	Non-Gov't Assisted *Condo.*	Starts *Rental*	Govt't Starts *Condo.*	Assisted *Rental*
1984	14,445	13,637	3,524	10,113	3,210	3,291	314	6,822
1983	19,972	19,617	2,493	17,124	2,325	4,777	168	12,347
1982	18,581	18,312	899	17,410	808	5,772	91	11,638
1981	20,188	18,904	3,174	15,730	2,285	7,779	889	7,935
1980	16,806	15,338	3,260	12,078	1,711	8,216	1,549	3,862
1979	20,727	19,266	7,328	11,938	1,560	7,711	5,768	4,227
1978	35,154	32,886	11,781	21,105	1,819	6,935	9,962	14,170
1977	48,867	37,422	22,020	15,402	3,522	5,382	18,498	10,020
1976	43,928	39,449	26,992	12,457	6,022	3,691	20,970	8,766
1975	37,756	34,703	24,309	10,394	9,247	3,775	15,062	6,619
1974	45,559	43,180	20,920	22,260	9,777	15,094	11,143	7,166
1973	59,835	56,841	19,794	37,047	9,920	11,114	25,933	9,874
1972	56,764	54,561	8,427	46,134	4,389	39,097	4,038	7,037
1971	51,497	49,597	7,652	41,945	3,586	31,873	4,066	10,072
1970	50,474	48,442	9,881	38,561	3,055	23,982	6,726	14,579
1969	45,962	44,483	3,586	39,897	1,578	27,543	2,008	12,345

SOURCES: Stanbury and Vertinsky (1986, p. 6-72). Data for 1969-1979 are from Smith and Tomlinson (1981); and derived from CMHC, *Housing Market Reports* and *Canadian Housing Statistics* for 1980-1984 by the Inquiry's staff.

> While it is clear that total rental starts in Ontario have been much lower in 1975 and later years (see Table 6-20), it is also true that they dropped sharply in 1974 (22,260) which is far below the average of 40,717 between 1969 and 1973. In other words, the slide started in 1974 a year before the extensive agitation for controls began in the spring of 1975 . . . In fact, there was overbuilding of rental units in the early 1970s.
>
> It is less clear how much the imposition of rent controls caused a decline in rental housing starts in Ontario. The following factors — even in the absence of controls — would have reduced the demand for or incentive to produce as many rental units annually in the period 1976-1984 as were produced annually between 1969 and 1974.
>
> – the number of new household formations declined from 81,400 per annum between 1971 and 1976 to 58,400 between 1981 and 1986
> – real interest rates rose from an average of 2.8% between 1971 and 1979 to 6.1% between 1980 and 1983.
> – the average annual unemployment rate in Ontario increased from 5.1% (1971-75) to 6.7% (1976-79) to 8.4% (1980-83);
> – real income per capita in Ontario grew at an average of 4.9% per annum between 1971 and 1975. It then fell to a rate of 2.1% (1976-79) and to 1.0% (1980-83); and
> – the removal of certain tax advantages and the enactment of tenant security of tenure measures.
>
> . . . While the influence of rent controls on the supply of new rental housing is debatable, what is clear is that the total supply of rental units has not kept pace with the increase in demand. (pp. 6-82 to 6-83)[24]

This point is illustrated by the submission to the Inquiry by the Region of Peel, Department of Housing which states:

> In the past, some have argued that rent review would not affect the supply of new rental units because it only applies to units built prior to 1975. Developers and builders have argued they will not build because they feared rent review would be extended beyond 1975. In

24. The significance of each factor is discussed in more detail in Stanbury and Vertinsky (1986, pp. 6-68 to 6-82) and in the cross-examination of Stanbury by Girard (Transcript 98-2, pp. 49-76).

> fact, between 1976 and 1985 almost 21,000 rental units were built in Peel Region. However, almost all of these have relied on the senior levels of government programs. A study entitled, *Rental Housing Programs and Their Impact in Peel Region*, showed that of the 15,892 rental units built between 1976 and 1982, only 203 were built without some form of program assistance. Since 1982, all of the 5,000 rental units completed were built under the available programs . . .
>
> Although rent review cannot be solely blamed for this situation, it must be seen as the most significant factor contributing to the lack of private rental starts. (Exhibit #135, pp. 13-14)

In the 1985 submission of the Social Planning Council of Metropolitan Toronto (SPCMT) entitled *Rent Review in Ontario and Factors Affecting the Supply of Rental Housing*, high interest rates are believed to be the principal cause of reduced levels of new rental construction. In their view, high interest rates worsen the negative cash flow position of an investment in its early years. High interest rates' effects are a major cause of uncertainty for the industry (p. 21). The SPCMT argues:

> High interest rates, aside from reducing rates of return in the rental development industry, also increase the attractiveness of lower-risk financial investments. (p. 20)

A study of *Rent Regulation and Rental Market Problems* prepared for the Inquiry by Clayton Research Associates Ltd. (1984) states:

> Almost all the province's new rental construction since the mid-1970s has been subsidized through various federal or provincial housing programs. (p. 16)

The authors then give reasons why investment in new rental projects has become less attractive than alternative investments. The first is:

> In most Ontario markets, economic rents — the rents necessary both to cover costs and to provide a reasonable long-term return on equity invested in new rental housing — are well above the rents prevailing for similar units in the existing stock — even those in the uncontrolled rental stock. This phenomenon is a result of increases in financing and construction costs and the constraints on overall market rents

> caused by rent regulation and past government subsidies for private rental projects. (p. 16)[25]

Another study prepared by Clayton Research Associates Ltd. (1984b) says:

> Rent controls . . . are a major impediment to new rental construction since they keep market rents below the level necessary to make unsubsidized new rental production viable. (p. 1)

Using the estimates of informed observers, Slack (1986) estimates that the shortfall in new rental housing starts was approximately 8,000 to 10,000 units in 1984. The estimate incorporates both unsatisfied new demand based on demographic trends and replacement of demolished and converted stock. No similar calculation has been made for other years but the aggregate reduction over the period of rent regulation must be several times greater than the 1984 shortfall.

1.4.4 Demolition and Conversion

The behavior of existing landlords, as well as that of potential new investors, is affected by the Ontario regulatory system. Stanbury and Vertinsky (1986) open their discussion of losses to the rental housing stock with the remark that:

> It is frequently argued that rent controls create economic incentives for landlords to try to remove their buildings from the controlled stock. This may be done in several ways:
>
> - conversion to non-rental activities including
> - ownership housing (condominiums, cooperatives or even single family in the case of smaller buildings, called deconversion)
> - conversion to non-housing purposes, e.g., office space
> - demolition following which a new structure is built which does not contain any rental dwellings
> - major renovations so as to move the units (perhaps fewer units) into an exempt category, e.g. "luxury" units [price over $750][26]
> - reconversion

25. This view is reiterated in Clayton Research Associates Ltd. (1984b) [for the Housing and Urban Development Association of Canada] p. 7.

26. Under the 1986 Act, this exemption no longer exists.

> It is difficult to obtain data on losses to the rental stock in Ontario that might be attributed to rent controls. (pp. 6-32 to 6-33)

Conversion, demolition and renovation are normal occurrences in the property market. As buildings age they periodically require major conservation work calling for new investment. In making such an investment, the owner normally will change the use of the building, say from rental to condominium, if the new use is more attractive financially. To the extent that any factor, including rent regulation, makes the current use of a building less attractive, owners are more likely to seek to change the use of the property. Further, a decision to convert or demolish the building will be accelerated by rent regulation since the benefits of doing so are increased by the amount that rent regulation depresses the property's earnings.

A witness,[27] who gave evidence with regard to the conditions in the low-rise housing market, spoke of four factors underlying market pressures in the low-rise stock. They were the age of the structure which was seen as the central underlying factor; constraints on revenue, that is to say the impact of rent regulation; location of older buildings which added to redevelopment pressures; and the fact that many low-rise buildings were easy to demolish and were situated on lot sizes which made it economically feasible to redevelop the site.

The survey extended to Toronto, Ottawa and Hamilton and led to what were referred to as valuable insights rather than predictions of the future:

> The survey of low-rise landlords conducted for this study revealed that a significant number intend to pursue options for their buildings which would result in either the rents increasing significantly, or the building being demolished or converted to another use. Using conservative assumptions regarding the likelihood of these intentions being realized, it has been estimated that 14% of the low-rise stock could be lost over the next ten years. This will affect all forms of low-rise rental buildings including both the ''plex'' structures and walk-up apartment buildings.
>
> . . . When the loss that is anticipated as a result of the physical deterioration of the low-rise stock is added to this figure, as much as 30% of existing low-rise buildings could be affected by some form of significant change over the next ten years. (Peter Barnard Associates, 1985, pp. 2.10-2.11).

27. The witness, M. Roland, conducted a survey of the stock of low-rise housing in Ontario in 1985 as an employee of Peter Barnard Associates which was engaged by the Ministry of Municipal Affairs and Housing to carry out the project entitled, *Under Pressure: Prospects for Ontario's Low-Rise Rental Stock*. See Transcript 130-2, Dec. 18, 1985.

The study concluded with the remark that while the problems under review were likely to be most prevalent in the major cities, other cities in Ontario were experiencing the trends to a lesser degree.

On the issue of losses to the rental stock due to the conversion of units from rental to ownership, MMAH reports that 7,859 units were converted in Ontario during the years 1975 through 1982. Annual figures are shown in Table 5 for both Ontario and for Metropolitan Toronto.

TABLE 5: Conversions to Condominium
(Existing units converted from Rental to Ownership)

Year	*Ontario* (Units)	*Metro Toronto* (Units)
1975	586	204
1976	2,190	1,292
1977	2,151	1,059
1978	784	396
1979	915	71
1980	673	138
1981	324	4
1982	236	42
Total	7,859	3,206

SOURCE: Ministry of Municipal Affairs and Housing and various regional municipalities as presented in *Staff Report to the Commission of Inquiry Into Residential Tenancies*, MMAH, February, 1983.

CMHC has collected more recent data on demolitions, renovations and conversions for buildings with six units or more in Metropolitan Toronto. Based on partial information[28] it found that there were a minimum of:

1,179 units demolished
(January 1978 through April 1985),

2,921 units renovated with tenants evicted
(January 1978 through April 1985)

28. The data are reported in CMHC, Toronto Branch, *Local Housing Market Report*, Supplement One, July, 1985, as revised December, 1985. There are several important limitations to the data. The time periods reported differed for the City of Toronto and the other municipalities. No data were available for certain categories of losses to the rental stock for North York, Etobicoke, Scarborough and East York. Most of the data reported were based on partial information; hence, actual losses would be higher. The amount by which the losses were underestimated is not known.

2,075 units converted to condominiums
(January 1978 through April 1985),

1,608 units converted to co-ownership
(January 1980 through April 1985), and

2,623 units converted to furnished rental
(January 1980 through April 1985).

1.4.5 Low Vacancy Rates

The adverse consequence of rent regulation in Ontario felt most directly by tenants is the low vacancy rate.[29] The vacancy rate is the difference between the number of units in a market available for occupancy and the number actually occupied. It is evident that, given fixed rental housing demand, the reduced return on investment will decrease the vacancy rate because, as discussed in the preceding sections, less new supply becomes available and the rate of removal of the old stock is accelerated. Since demand is not fixed, the impact of rent regulation on vacancy rates also depends on its impact on rental housing demand.

There is no clear empirical evidence that rent regulation in Ontario has had any measurable impact on demand. The general view based on theoretical arguments, however, is that demand would be increased, if anything. With generally lower rent levels, more people would be in a position to establish an independent household and would want a separate housing unit, if they could find one. In addition, some young couples may defer purchasing a home if they are getting cheap rent and more empty-nesters may be enticed to sell their homes and move to apartments if they have access to an inexpensive rent controlled unit. The only counterbalancing factor is that some tenant households may be able to save a downpayment for a home of their own more quickly as a result of lower rents in their controlled units.[30] Nevertheless, it appears safe to conclude that rent regulation tends to increase demand for rental housing.[31] That will further aggravate the low vacancy rate problem.

29. See Appendix F for a detailed discussion of the measurement of, and data on, vacancy rates in Ontario.

30. See the study by R. Blatt (1982, p. 38). See also the testimony of P. Goring in Transcript 118-2, pp. 48-49, J. Bassel in Testimony 97-2, pp. 131-133 and L. Smith in Transcript 36, pp. 75-76.

31. Since 1975, factors such as demographic trends and slow economic growth have dampened the increase in rental housing demand. If it were not for those factors the imbalance between supply and demand would be even more severe than it is now.

For the foregoing reasons, it should not be surprising that a prominent feature of the rent regulation decade has been a declining vacancy rate in most of the residential tenancy markets in Ontario.

The only authoritative vacancy rate data is found in twice yearly surveys made by CMHC. Although several technical criticisms may be made of the CMHC vacancy surveys, as discussed in Appendix F, they provide the best available indicator of changes in the tightness of the rental housing markets surveyed. The surveys are restricted to the 10 CMAs in the province but cover 37 per cent of the urban population and 34 per cent of the rental stock.[32]

The data in Table 6 regarding rental apartment vacancies from 1971 to 1984 show that it is necessary to consider each region separately rather than using average vacancy data for the whole province. That table shows that except for Hamilton and Kitchener, vacancy levels in 1977 had fallen below two per cent in the rest of the province and thereafter, except in 1979 and 1980, generally showed a continuing decline to the present levels of uniformly less than one per cent. Current vacancy rates are extraordinarily low from an historical perspective and compared to other jurisdictions at the present time. As shown in Appendix F, although several factors other than rent regulation have slowed the growth of both supply and demand for rental housing, Ontario's system of rent regulation is responsible for creating this crisis in rental housing availability.

The chronic scarcity of rental housing evidenced by the continuing low vacancy rates presents no immediate problems for households already accommodated and content to stay where they are. Prejudicial consequences will be felt if and when the household must move or when a move would be desirable or advantageous but must be deferred because of the difficulties in finding accommodation in a new locality. For example, some tenants may be reluctant to accept a change in employment which requires relocation because comparable accommodation in the new locality may be difficult if not impossible to find. When a move must take place the tenant households are faced with higher transaction costs of searching for new housing than would be the case if the market was not so tight. Furthermore, they are considerably restricted as to where they can live and the kind of accommodation they must accept.

Efforts have been made to put dollar amounts on these costs or more properly on the disadvantages and burdens placed on tenants and prospective

32. Derived from Pringle (1986, Tables 1.13, 2.6 and 2.7) and MMAH (1983, Table 5). Survey representation varies by CMA from 28 per cent in Thunder Bay to 59 per cent in Toronto, but averaged 45 per cent for the 10 CMA's. The 10 CMAs contain 74 per cent of the total rental stock and 82 per cent of the urban tenant population. Vacancy surveys cover .45 x 74% = 33.5% of the rental stock. .45 x 82% = 37% of the urban tenant population.

TABLE 6: Vacancy Rates[1] In Ontario CMA'S, 1965-1985 (Percent)

Area	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Hamilton	1.4	1.5	1.4	1.9	1.3	2.2	2.2	2.2	2.3	1.9	2.4	3.1	4.3	3.9	2.5	1.5	0.9	0.6	1.0	0.7	0.4
Kitchener	—	—	—	—	—	5.4	6.3	3.3	4.5	5.1	2.7	3.0	2.9	2.7	2.3	1.7	1.2	1.0	1.6	0.7	0.4
London	—	—	—	—	4.0	4.9	4.4	6.0	6.5	4.4	2.8	2.3	1.9	2.2	4.3	5.0	2.9	2.8	3.1	1.7	0.7
Oshawa	—	—	—	—	—	—	—	—	—	—	—	—	1.6	1.7	3.1	2.7	0.6	0.4	1.4	0.9	0.1
Ottawa	—	7.7	2.2	1.5	1.5	1.9	1.8	2.0	2.1	3.4	2.3	2.1	1.7	1.5	3.0	3.9	1.4	0.3	0.3	0.3	0.9
St. Catharines Niagara																					
Sudbury	—	—	—	—	—	0.3	0.3	5.2	10.5	6.9	2.1	1.2	1.2	5.4	8.5	2.7	1.3	1.1	1.2	0.9	0.8
Thunder Bay	—	—	—	—	—	—	—	0.8	1.4	1.3	0.6	0.3	0.3	1.3	1.6	1.3	1.6	1.1	0.9	0.9	0.5
Toronto	1.6	1.0	1.2	1.5	2.5	2.8	3.3	2.9	1.8	1.1	1.5	1.3	1.1	0.9	1.2	0.8	0.4	0.6	1.1	0.7	0.5
Windsor	—	—	1.1	1.6	0.6	1.4	2.0	2.0	2.5	2.1	3.4	2.5	1.3	1.0	1.4	4.9	7.7	5.2	2.4	0.9	0.7

NOTE: 1. For privately initiated buildings containing 6 or more untis. Excludes buildings constructed within 6 months of the survey dates. Data for 1965 to 1968 are for June; thereafter the estimates are averages of the twice yearly surveys.

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, various years.

tenants but the results are not particularly persuasive. That there is, however, an appreciable though unmeasurable cost cannot be doubted.

Those prejudicial consequences may be felt whether an existing household wishes to move within the province from another rental unit or from an owned home to a rental unit; whether a household wishes to move to Ontario from outside the province; or whether an individual or family wishes to establish a separate household by leaving accommodation shared with parents or roommates. Overall, many individuals experience the frustration of low vacancy rates if they persist for a significant period of time.

1.4.6 Key Money

In an unregulated market, if the vacancy rate is low, landlords are able to charge a premium for their units. Scarce rental units go to those who are willing and able to pay the most. In Ontario, where the vacancy rate is low but rents are regulated, landlords are unable to charge high rents for units which become available even if there is a line-up of people willing and able to pay a premium. As a consequence, other mechanisms are used to allocate units. Landlords may choose tenants who are unlikely to cause managerial inconvenience. It is commonly the case, however, that tenants control the turnover of their rental units when they move out because of the security of tenure provisions of the Ontario Landlord and Tenant Act.

Units attractively located or priced may be passed on to friends or relatives by departing tenants. In some cases, outgoing tenants charge key money which has the effect of circumventing the regulatory system and of allocating units on the basis of who is willing and able to pay the most for the unit. Key money takes the form of requiring that the incoming tenant purchase such things as carpeting or draperies at an inflated price, or it can be an outright cash payment for the right to obtain the unit. Key money is the direct result of rent regulation and serves as a substitute for the rent increases which otherwise would occur. In effect, the principal differences between a unit being let in an unregulated market and a unit being exchanged for key money under the current Ontario practice are: 1. the premium is paid in a lump sum rather than in the form of a higher rent; 2. a tenant who pays key money may have the prospect of recovering that outlay by charging key money to the next tenant; and 3. the departing tenant rather than the landlord collects the premium paid by the incoming tenant.

Evidence regarding the practice of charging key money is difficult to obtain. Mascall, in his 1985 study for the Inquiry, attempted to determine the extent of the practice in Toronto as of August, 1985. He found evidence that key money demands are made largely for apartments in the central part of

Toronto. The practice is not reported in the suburbs. The situation may be changing with the continuing low vacancy rates in all parts of the province.

However, when the vacancy rate declines enough to create a true scarcity of units in particular locations or units of a particular type, some variant of key money becomes virtually inevitable.[33]

1.4.7 Higher Rents for Uncontrolled Units

Under the 1975 Act and the 1979 Act, portions of the Ontario rental market were exempt from rent regulation.[34] For those segments of the market landlords could raise rents in response to low vacancy rates rather than resort to the alternative means of allocating scarce units mentioned in the previous section.

Economic theory shows that if the landlords of new buildings are able to charge rents above the competitive rent level, they will earn excess profits. The opportunity to earn excess profits should attract additional investment which, over time, will eliminate the supply shortage and increase the vacancy rate. However, in Ontario, the future of the regulatory system has been uncertain. As a consequence of that political risk, new investment has been limited. Virtually all new investment either has been in socially assisted housing or in condominiums which, even if rented initially, can be removed from the rental market and sold as ownership units relatively easily. This would be done if the rules of the regulatory system are changed so as to threaten the profitability of those buildings when operated as rentals. The consequence of uncertainty has been that rents for new buildings have remained higher than they otherwise would have been and the investment needed to reduce the supply shortage and increase vacancy rates has not been realized.

33. The 1986 Act, in a broadly worded provision under the marginal note of "additional charges", prohibits landlords and tenants from collecting and attempting to collect key money in any form or manner whatever and provides penalties for contravention. Under the Act key money joins unauthorized rent increases as illegal practices punishable on conviction by a fine. Whether they will be eliminated or merely driven underground probably will turn more on whether rent regulation is seen as moderate or restrictive than on the application of penal sanctions.

34. Those exemptions are discussed in Chapters 1 and 14, and sections 4.8 through 4.10 of Chapter 4 of Volume 1. Since the publication of Volume 1 of the Report, the exemptions have been eliminated. The $750 exemption was revoked on November 15, 1984. Under the 1986 Act, regulation now has been extended to include buildings constructed since January 1, 1976. Despite the elimination of the exemptions, rents for units which were exempt will continue to be higher than rents for similar units which always were controlled. That is the case because the 1987 rents for previously exempt units are higher and post-1975 rental buildings have more generous cost pass-through provisions in the form of an allowance for economic loss.

Slack (1986) reviews several studies which attempted to quantify the extent to which rents for uncontrolled units have been increased as a consequence of rent regulation in Ontario. She concludes that:

> . . . the loss to tenants of uncontrolled units is between 9 and 10 per cent of their gross rents. (p. 20)

That is to say, the 1984 rents for units which were not rent controlled appear to have been nine to 10 per cent higher on average than they would have been in the absence of rent regulation.

1.4.8 Deterioration in the Housing Stock

Stanbury and Vertinsky (1986, pp. 3-20 to 3-28, 6-41 to 6-42) argue that rent regulation leads to a decline in expenditure by landlords of controlled properties on repairing and maintaining their properties and in conserving their structural features.[35] One explanation advanced is that because of rent regulation landlords do not have the funds necessary to do what they know should be done and wish to do. When rents are held down without there being restraints on operating costs, landlords have a smaller cash flow out of which to cover the cost of maintenance and conservation than they would have in the absence of regulation. Furthermore, financial institutions are less interested in lending funds to landlords whose rents are regulated since the cash flow out of which they must repay loans is reduced.[36]

The Inquiry heard evidence regarding maintenance from experienced managers of large-scale rental housing operations in Ottawa, London and Toronto. The property managers, some of them owners as well, were unanimous in their opinion that because of reduced income due to rent regulation it was not feasible to keep the premises for which they were responsible up to former standards. None of them attempted to give a percentage rate of deterioration but all were firm in saying that deterioration had taken place and the situation could only become worse. Attention was drawn by the witnesses to the low vacancy rates in controlled buildings and the effect this could have on tenants' acceptance of lower standards.

The data necessary to demonstrate empirically whether or not cash flow is adequate to keep up traditional maintenance and conservation standards are not available. It is clear, however, that for many landlords, the profits they

35. The distinction drawn by Klein and Sears (1983) between maintenance and conservation is used in this Report. See Appendix G for an explanation of the difference.

36. See the report of Environics Research Group (1984), of particular relevance sections 3.3.2.4 and 3.3.3.1 to 3.3.3.6.

can expect from their buildings have been restricted to the point where they are reluctant to invest additional funds in maintaining and conserving their buildings. That is particularly true of landlords who have not applied for a whole building review to pass through increases in costs in excess of the statutory rate of increase.

It is also apparent that although landlords have the option of going to rent review to gain the requisite rent increase, many choose not to because the costs, delays and frustrations of the process make a policy of cost saving preferable. Moreover, landlords say that if they go to rent review, there is no assurance that any increase in rents which may be allowed will fully recoup the expenditure, particularly for a substantial conservation project.

This view was expressed in the submission by the Region of Peel, Department of Housing (1985):

> Rent review, it is claimed by some, does not affect building maintenance. The private landlord can apply for a rent increase in excess of the limit, if the maintenance costs are justified. Unfortunately, it is not that simple. Applying for a rent increase above the limit is a lengthy process requiring a lot of time, money, and professional assistance. In the end, there is no guarantee that the rent increase sought will be granted. Should a private landlord lose the case, maintenance spending will likely be cut to make up for the loss in revenue. In any case, it is far easier to cut maintenance costs, than to go through the process of rent review. (p. 19)

Aside from the effect rent regulation may have on the availability of funds for maintenance and conservation, the incentive to undertake such expenditures has been significantly altered by rent regulation. Because of excess demand as evidenced by the abnormally low vacancy rates in the controlled market, landlords can let their premises run down and still have no difficulty in renting their units. Nor need they be too concerned about elevator breakdowns and defective heating systems which cause discomfort to their tenants and might result in their moving out. For many tenants the difficulty involved in finding other accommodation at comparable rents will incline them to put up with conditions which otherwise would not be tolerated.

Submissions to the Inquiry regarding reduced maintenance and conservation expenditures argued on one hand that landlords who see the market value of their property falling will withdraw their equity by cutting back whenever possible on expenditures in order to increase the return.[37] On the

37. See the testimoney of J. Lang, Transcript 39, p.146, and L. Smith, Transcript 36, p. 33-34. See also Slack and Amborski (1984, pp. 11-12) and Stanbury and Vertinsky (1986, 3-27).

other hand, a landlord applying for rent review will be granted a rent increase which depends in part on the increase in operating costs and on the value of capital expenditures undertaken. In order to be granted a large rent increase, it would be in the interest of the landlord to spend money on maintenance and conservation so as to maximize the rent increase which can be justified. That incentive had some potential to encourage maintenance and conservation.[38] However, the incentive is there only for landlords who choose to apply for rent review and only in the years where it will affect the rent increase granted. In practice, the amount of the cost increases to be passed through can be inflated by cutting back on expenditures on maintenance and conservation in the years prior to a rent review application and loading expenditures into the projected year.[39]

Appendix G surveys a number of studies which address maintenance and conservation in the Ontario rental housing stock. Although little evidence of a decline in standards was shown by those studies, it must be pointed out that they all have serious methodological flaws. None provide a consistent and objective measure of the level of maintenance in the Ontario housing stock which can be used to compare the rates of deterioration of buildings as they age with and without rent regulation. In addition, several experts expressed concern that a decline in maintenance expenditures does not show up immediately — rather it creates a cumulative effect in terms of the severity of impending problems. When delayed maintenance becomes acute the visibility of deterioration may increase rapidly and the cost of repair can be much more than if maintenance standards had been kept up. Furthermore, where the evaluation of maintenance standards was made by tenants, rent regulation may have reduced their expectations. Their low expectations may have been reflected in their response to the questionnaires. Even though it may be a chronic condition of controlled rental housing, under-maintenance is not seen as a crucial problem by tenants and may be tolerated by them as a tradeoff for reduced rents.

The position of the Inquiry is that despite the evidence in the surveys, the combined weight of the logical consequence of reduced rent flows and the evidence of experienced property managers whose business it is to monitor the condition of their properties indicates there is a problem of maintenance de-

38. Under the 1979 Act, the advantage accruing to a landlord from a capital expenditure lay in the indefinite continuation in the allowed rent of an item derived from the expenditure after the actual amount of the expenditure had been recovered by rent increases. This loophole, referred to as a cost no longer borne, has been closed under the 1986 Act by subsection 76(2) when tenants take the necessary action.

39. This is discussed in Volume 1, sections 9.3, 11.1.1 and 11.1.2.

terioration which currently is not pressing but, if allowed to continue, could become significant.

1.5 Direct Costs of Regulation

In addition to the effect of rent regulation on price and the consequences of that price effect which have been discussed in the preceding sections, it is relevant to consider the direct costs of rent regulation. For purposes of this discussion, the direct costs are divided into three categories. The first are the costs borne by tenants and landlords which are referred to in economic literature as the cost of "rent seeking" activities.[40] The second and third cost categories represent costs borne by government, or to put it more accurately, by taxpayers generally. They are the cost of administering the regulatory system and the cost in terms of foregone tax revenue which results from reduced rental income and decreased investment in maintaining existing buildings and constructing new rental buildings.

1.5.1 The Cost of Rent Seeking Activities

Both landlords and tenants incur costs associated with rent seeking activities. Those activities include the efforts of landlords and tenants, both as individuals and as organized groups, in seeking favourable changes to the existing system. The costs of rent seeking also include the cost associated with complying with the existing regulatory system and participating in rent review hearings.

Slack (1986) observes that the cost of rent seeking activities can be divided into two components: lobbying costs and procedural costs. She states:

> Lobbying costs are those incurred when trying to get favourable (or restrict unfavourable) legislative and administrative policies. These costs, it should be noted could also be incurred in the absence of controls.[41] Procedural costs (or compliance costs) are those costs incurred in securing the favourable application (or avoiding unfavourable application) of existing laws and policies. These latter costs which are borne by landlords, tenants and taxpayers would only occur when controls are in place. (p. 17)

40. Rent seeking is an economists' term meaning the costs related to the struggle or effort to secure a share of "rents", defined as non-exclusive rights to income or wealth, which have been created directly or indirectly by government intervention. Those "rents" are not the same as the rents tenants pay.

41. See Hartle (1984). Lobbying costs are incurred when there is uncertainty about changes. Hence, as long as the system is volatile, they will continue to be incurred.

Lobbying and procedural expenditures are tangible outlays frequently involving out-of-pocket expenditures. They also include the time spent by individuals in activities such as preparing for, and appearing at, hearings. Estimates of the amount of these costs can only be tentative. They are nonetheless conspicuous and irritating to both landlords and tenants.

Slack (1986) concludes her summary of the evidence pertaining to the amount of rent seeking costs with these words:

> The estimate for lobbying costs on the part of landlords and tenants for *1981* is estimated to be $2 million. Although these are economic costs, the measures are crude and since it was argued that they would be incurred even in the absence of rent review, it is not clear how much of these costs should be attributed to that policy. (p. 17)

1.5.2 Administrative Costs

A cost directly resulting from rent regulation, which to date is borne entirely by the general revenues of the province, is the direct administrative cost of the program. The Report of the Residential Tenancy Commission for the fiscal year ended March 31, 1986, showed its cost of operation to be $7.9-million. The Inquiry has no means of forecasting the cost of operating the regulatory system introduced by the 1986 Act. It is unlikely, however, that the costs of administering the Act including the administrative body within the Ministry of Housing which will issue initial orders, the Rent Review Hearings Board, the Residential Rental Standards Board and the administrative body responsible for the rent registry, will be less than the cost of the RTC.

1.5.3 Foregone Tax Revenue

A further cost to the public treasury resulting directly from the reductions in rental payments due to rent regulation is foregone tax revenues. Slack (1986) summarizes the prior relevant studies of this phenomenon and provides ranges for the relevant tax losses. See Table 7. She describes foregone tax revenues as transfer costs in that they represent a transfer of services from one group in society to another. The description is apt if one approaches government financing as a process of budgeting expenditures and then taxing and borrowing to cover the expenditures. Municipalities can only tax property and then under strict control. The federal and provincial governments can both tax and borrow to finance their expenditures. In any case the tax not paid by or collected from one source must be obtained from another.

Table 7: Foregone Tax Revenues Ontario, 1984

	($ million) lower limit	upper limit
income tax[1]	51.9	101.9
property tax[2]	70.0	80.0
capital gains tax[3]	36.0	50.4
provincial capital tax[4]	2.3	3.8
	160.2	236.1

NOTES: 1. Federal and provincial, corporate and personal, noting reduced tax paid by landlords and increased tax paid by tenants on rent savings.
2. Reflecting the decrease in the tax base due to properties not constructed and reduction in the market value of existing properties.
3. Payable on the reduced profits from the sale of rental property.
4. Reflecting the decrease in the corporation capital tax base due to reduction in sale prices.

SOURCE: Slack (1986).

1.6 Distributive Impact of Rent Regulation

In evaluating the Ontario system of rent regulation, it is important to consider not only the aggregate impact of the system but also the distribution of costs and benefits. The distribution of costs and benefits can be more important than the average effect when evaluating what the system actually does and does not accomplish.

Empirical studies[42] of the distributive impact of rent regulation found that the effect of rent regulation is mildly progressive in distributing net benefits among tenants, assuming all rents are held down proportionately. Lower income households tend to receive greater benefits as a percentage of income than higher income households because a large proportion of low-income households rent and tend to pay a larger portion of their incomes in rent. From the landlords' side, the studies assume that the distribution of investment in rental housing is the same as the distribution of investment generally by income level.

Four considerations are important to interpreting those findings. First, the definition of progressivity requires only that the benefit of rent regulation for a low-income household is greater as a percentage of income than it is for a higher income household. That does not necessarily mean that the actual dollar amount of the benefit is less for high-income households than for low-income

42. Studies which provide empirical estimates of the distributive effects of rent regulation in Ontario include: Fallis (1980), Blatt (1982), Miron (1981), Miron and Cullingworth (1983) and Stanbury and Vertinsky (1986). See Slack and Amborski (1984) for a more extensive review of this material.

households. Second, all rents are not held down by the same percentage of the competitive market rent level. Certain tenant groups may have advantages in gaining those units for which rents are held down the most. Third, certain types of rental housing, specifically units in small buildings, tend to be owned by relatively low-income investors, hence the assumed distribution of the costs of rent regulation may be misleading. Fourth, whatever the distributive impact on average, it is evident that there is little direct correspondence between income and the net effect of regulation in specific cases. The rent that may be charged for a unit is not related to the income of either the landlord or the tenant.[43]

With regard to the consideration that landlords of certain types of buildings tend to have lower incomes than investors generally, there are insufficient data available to clearly determine the facts. Nevertheless, it is widely recognized that a large proportion of small landlords are by no means wealthy.[44] Many depend on the income from a small building with three or four rental units as their primary source of retirement income. Others work full-time, frequently in the building trades, and own a building on the side. They may spend many hours investing "sweat equity" to increase the value of their building. Again, their investment in the building frequently represents their total personal wealth. This leads to the consideration that although for many purposes residential rental housing must be approached as a whole industry, the fact is that at the same time it is an agglomeration of more than a hundred thousand landlords each with unique characteristics. From that point of view, when weighing the benefits to their tenants of a few dollars of rent reduction, the interests of small landlords must be examined — especially given that the benefits are not dependent upon the tenants' income being low.

The most important limitation on the analysis of the progressivity of rent regulation is the fact that the average effect is not indicative of many individual circumstances. It is misleading to focus on the averages. As Slack and Amborski (1984) observe: "The benefits depend on whether a family has a unit in the regulated or unregulated sector, how much housing they consume, the provisions of the rent regulation scheme, and whether the residents are new to the community." (p. 44)[45] Those factors have little to do with income or the need to receive financial benefits to resolve an affordability problem.

43. The tenant-related distributive issues listed here are interwoven with the affordability concerns discussed in section 1.4.1. In this section the remaining issues are discussed.

44. Blatt (1982, pp. 21-28), Miron and Cullingworth (1983, pp. 144-149) and the general testimony of J. Andrade, Transcript 107-2 and R. Doumani, Transcript 107-2.

45. A study by Fallis and Smith (1985) produced a similar distribution of benefits and costs among tenant households in the regulated and unregulated sectors. Fallis and Smith state that

It may also be noted that there are instances of unfairness and inequity for both landlords and tenants under the existing Ontario scheme of rent regulation. A distinction must be drawn between unequal treatment under the Act, and in practice as the system is administered.

In the first category, inequality of treatment arises because the circumstances of landlords relative to others are not taken into account in determining the rents they are permitted to charge. Two landlords may own similar buildings with similar operating costs in equally attractive locations which would command similar rents in an unregulated market. Even, if one has lower rents and lower profitability, if the costs of both buildings are increasing at the same rate, they will both be permitted the same percentage increase in their rents even if they go to rent review.[46] The landlord with higher rents and higher profits will receive a larger absolute increase in revenue since the rent base for that building is higher.

Furthermore, the treatment of financial costs favors a purchaser as compared to a continuing landlord and is prejudicial to the tenants of the purchaser in that large rent increases are allowed frequently because of the new borrowing required to finance the purchase.

Unfairness and unequal treatment in the operation of the scheme can occur in several ways:

1. prior to the introduction of the 1986 Act the absence of an effective and comprehensive monitoring and enforcement policy and of a rent registry permitted landlords who are prepared to impose illegal increases, to do so with a considerable degree of freedom.[47] This was prejudicial to their tenants and unfair to landlords who obeyed the law or rent review orders as the case may be;
2. the complexity of the review procedure and the cost of preparation required for a successful result is such that it favors sophisticated landlords of large complexes and is beyond the financial and business capacity of small landlords.

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rent regulation is mildly progressive since there are four times as many households in the regulated as in the unregulated sector and the average income of households in the regulated sector is 82 per cent of those in the unregulated sector. Fallis and Smith conclude that the main beneficiaries of rent regulation are not low income households.

46. If one or both landlords suffer from a financial loss, or an economic loss under the 1986 Act, or have chronically depressed rents as defined in the 1986 Act, the inequity may be alleviated. These circumstances, however, will resolve only a fraction of the inequities which currently exist.

47. The effectiveness of the 1986 Act in deterring illegal increases has yet to be seen.

1.7 Concluding Comments

Ontario's system of rent regulation was introduced in 1975 as a temporary measure but it has now been in place for more than a decade. Furthermore, some form of rent regulation is likely to continue to be a feature of the residential rental market in Ontario for the forseeable future. Consideration must be given to the question of whether the cost pass-through form of rent regulation introduced in 1975 is an appropriate way of regulating rents on a long-term basis.[48]

The evidence discussed in this Chapter shows that Ontario's system of rent regulation has, in general, held rents down for controlled rental units. While the average rate of rent increase for those units has been slowed, however, the regulatory system has not protected tenants against unexpected large increases in particular instances. Yet it was the fear of large increases which was a major reason for promoting rent regulation in 1975.

The consequences of holding down rents have been numerous. Landlords' incomes have been reduced as have the capital values of their buildings. This has discouraged investment in rental housing as evidenced by decreased private sector development, and the widespread desire among landlords to convert their properties. A depressing influence on new investment has been that rent regulation has encouraged tenants to continue to occupy "cheap" controlled units and made them unwilling to pay the rents which would make new buildings an economical venture for potential investors. The controlled units in older buildings which might have been occupied by lower income tenants have not become available. The controlled rents also tend to make rental housing more attractive than ownership, thereby increasing rental demand. With a financial disincentive to invest in rental housing since the introduction of rent controls, virtually all high-rise development has been in socially assisted units or condominiums. In terms of unsatisfied new demand and replacement of demolished or converted stock, Ontario's shortfall in new rental housing starts in 1984 was estimated between 8,000 and 10,000 units.

Vacancy rates have been excessively low in many Ontario cities. Because of the tight market conditions, available units are in high demand, hence, key money and other inducements are often required to obtain controlled units in prime locations. Furthermore, the incentive to maintain and conserve rental buildings is reduced and the quality of the housing stock beginning to deteriorate.

In addition to those consequences in the marketplace, rent regulation has introduced direct costs which must be borne by landlords, tenants and taxpayers. Those include the costs associated with rent-seeking activities, admin-

48. Whether or not that regulatory system was appropriate as a short-term measure in 1975 is a separate question which is not relevant to the recommendations in this Report.

istration of the regulatory system and foregone tax revenues due to reduced rental income, reduced property values and reduced construction activity.

Only a disproportionately small part of the monetary benefits of regulation has accrued to those households which were most vulnerable to financial hardship as a result of the increases which might have occurred in the absence of a rent regulation. The evidence indicates that the monetary benefit to tenant households with incomes above the median is about four times greater than the benefit to those with incomes below the median. That inequitable distribution of benefits among tenants is accentuated by the tight market conditions. Households with high income, no children and other features attractive to landlords are far more likely to get the best rent controlled bargains than lower income, larger households who are struggling to make ends meet.

The existing scheme of rent regulation also fails to treat landlords equitably since only in limited circumstances are the rents landlords can charge based on considerations which include a determination of the adequacy of the return on equity. A further equity concern from both the landlords' and tenants' perspectives is the lack of a mechanism to ensure rents for similar units are similar. Hence, there is little relationship between the rent charged and the value provided to the tenant.

At its inception, rent regulation in Ontario had an appparent virtue of logical simplicity. Rents would be allowed to increase only in proportion to cost increases. The statutory rate, which was meant to reflect the prospective rate of cost increase, was determined arbitrarily. If the rate of eight per cent at first and then of six per cent per annum was adequate, it became inadequate when costs including interest rates ran up to double digit levels a few years later. The inequity of the fixed rate was compounded when it was reduced to four per cent in keeping with the reduction in costs with no allowance for the intervening period of high inflation.

The system also was inequitable from the tenants' point of view. Not all landlords were operating at a loss when regulation was imposed. For an unknown but probably not insigificant proportion of landlords, the fixed rent increase limit was adequate. In some cases it could have been even more than the landlord would have charged but it was charged anyway. The opportunity originally given to tenants by the 1975 legislation to question the need for taking the full statutory increase was removed in 1979.

At the same time, the system from its inception incorporated the safety valve, for landlords, of rent review. If a landlord could show that cost increases justified a rent increase greater than the statutory limit, it would be allowed. The interprètation given to the statutory direction regarding financial loss opened the way to the notorious practice of ''flipping'' rental properties to take advantage of the resulting increase in financing costs and consequent increase in rents. This was possible in cases where the original landlord had been bound

by the statutory limit and rents had been kept below market levels. In Volume 1 of this Report attention was drawn to this and other ways of playing the rent review game to the advantage of the landlord.

One of the great faults in rent regulation since 1975 has been the complete failure to compile statistics which would reveal the impact of regulation on the operation of the whole market. Information regarding the number of rent review applications and the rent increases allowed does not reveal the effect of regulation on landlords and tenants generally.

The operation of the system also has been marred by the lack of effective monitoring and enforcement procedures. Any regulatory system which restricts normal market operations is subject to being avoided or evaded outright. Moreover, a system which is unduly sophisticated and complicated as is the case with rent review in Ontario, favors the larger operators who can engage the special services required to make the system work to their least disadvantage.

The recent amendments to the scheme of rent regulation do not affect its essential features. The result is a complex statute of 120 sections which determines rent increases by the application of formulae. No mechanism is included for ensuring that the rents allowed are fair rents. That is an inherent deficiency of cost pass-through rent regulation because it sets just the rent increase and does not go the further step of setting the rent itself. That deficiency is examined analytically in section 3.1.3.1

If the cost pass-through provisions of the 1986 Act are interpreted and applied restrictively with the intent of holding rents below market levels, the adverse consequences to which attention has been already drawn — including more sophisticated avoidance measures by landlords — will continue to prevail. In that event an even more complex, administratively burdensome and expensive system of rent regulation will be the next step.

This Report addresses the question of whether some approach to rent regulation other than cost pass-through is better suited to serve as a long-term regulatory system. To answer that question, the analysis contained in this Report starts with the fundamental issues — what is a fair rent. Alternative types of rent regulation and other non-regulatory policies which can be used to resolve rental housing market problems are then examined. Following that discussion, the problems which must be considered in designing a regulatory system are examined so that the policy objectives which form the bases of the Report's recommendations can be identified. The Fair Market Rent (FMR) system of rent regulation which is outlined in Chapter 5, forms the centrepiece of the recommendations.

Chapter 2

Views Regarding Fair Rent

Fairness, as in fair rents, is central to the mandate for this Inquiry. In the Order in Council the phrase ''fair and equitable[1] treatment of landlords and tenants under a system of rent review'' appears in both paragraphs 1(f) and 2. In addition, the Inquiry is directed in paragraph 3 to recommend measures to provide ''rental accommodation at fair rents''. This Chapter is directed to the question of fairness and what constitutes a fair rent, and reviews the merits of regulation and market competition as alternative modes of achieving fair rent.

A feature of the private market[2] which pervades any discussion of fairness is the inherent conflict of interest between landlord and tenant. A market by definition involves a seller and a buyer of a service or commodity and in every market there is a degree of tension between the two participants. For a number of reasons, particularly the economic and social importance of housing to tenants, the tension in the rental housing market can be severe which increases the difficulty in coming to an understanding with regard to the fairness of rent.

Landlords and tenants approach the question of the amount of rent which should be collected and paid with different perceptions of fairness. The Inquiry is not aware of any study which has attempted to identify and analyze the concepts of fair rent. This Chapter attempts to remedy that deficiency. It is

1. The words ''fair and equitable'' which together set the standards for the Inquiry's task, are synonymous. For the sake of brevity and convenience in this Report the word ''fair'' is used alone carrying with it as it does the meaning of ''equitable, without bias, even-handed.'' (Black's Law Dictionary, p. 713)

2. Because socially assisted housing is exempt from rent review, it is implied in the phrase ''under a system of rent review'' quoted above that the Inquiry's attention is directed to the private rental market and the landlord and tenant relationship in that market. Socially assisted housing is rental housing which is exempt from rent review by clauses 134(1)(a) or (b) of the 1979 Act, now clauses 4(2)(a) or (b) of the 1986 Act.

important to identify the principles inherent in each view of fairness and also to examine the consequences of regulatory programs which might be employed to implement different concepts of fair rent.

Three criteria by which the fairness of rents can be determined are:

1. tenants' ability to pay,
2. landlords' return on investment, and
3. market competition.

The three criteria are fundamentally different. Ability to pay is the basis for determining whether the rent a household pays is affordable by it. In this Report a rent which is affordable by a household is said to be socially fair. Socially fair rent is discussed in section 2.1 below. Return on investment is the basis for determining whether the rents paid are fair for the landlords. If they enjoy a fair return on their investment it is said in this Report that they are charging fair market rents. Fair return can be the subject of regulatory control or the outcome of free market competition. Fair return and fair market rent are discussed in sections 2.2 and 2.3 below. Fair market rent must be distinguished from the actual market rent which at any particular time may be less or more than fair market rent.

Socially fair rent may be seen as a tenant concern and fair market rent as a landlord concern; however, during the Inquiry's hearing process landlords and tenants recognized that in formulating policy, government must take both views into consideration. Tenant witnesses acknowledged the need for landlords to receive a fair return on their investment[3] and landlord witnesses acknowledged that many households need assistance to avoid being overburdened by their rental costs.[4] Differences of opinion centred on whether or not actual market rents exceed fair market rents, and on how to assist households which cannot afford the fair market rent for the unit they occupy.

This Chapter addresses the question of fairness on a conceptual level as a necessary first step to identifying desirable objectives. Later chapters deal with the practical difficulties of realizing the concepts identified in this Chapter.

3. A Johnston, Alderman, June 21, 1983 (Tr. 42, p. 130), D. Leitch, Sudbury Community Legal Clinic, June 15, 1983 (Tr. 41, p. 42), E. Frerichs, Social Planning Council of Metropolitan Toronto, April 29, 1983 (Tr. 30, p. 132) and S. Goetz-Gadon, Metro Tenants Legal Services, March 8, 1983, (Tr. 8, p. 6).

4. A. Richman, Forward Management Services Limited, January 16, 1986 (Tr. 137-2, p. 31), J. Bassel, Arcadia Group Investments Limited, June 14, 1985 (Tr. 97-2, p. 151) and A.E. Diamond, Cadillac-Fairview Corporation Limited, (retired), December 3, 1985 (Tr. 127-2, pp. 63-64).

2.1 Tenants' Ability to Pay

Actual market rents can be judged to be socially fair or unfair based on the ability to pay of the affected household.[5] The rent charged for a unit is not socially fair or unfair in itself, but only with respect to the income of the household paying that rent. This concept of fairness does not relate to whether it is fair from the landlords' point of view to charge a particular rent, but whether it is fair from society's point of view that a household, given its income and its housing needs, should have to pay that rent.

There is no ''correct'' way of determining whether a household's rent is socially fair since there is no objective standard for determining what rent is affordable or what standard of housing is adequate for a particular household. Nevertheless, for purposes of setting policy, the government must adopt a practical definition of socially fair rent. The commonly accepted view is that a household should not have to pay more than about a quarter of its income on rent. The percentage figure ranges from 20 to 30 per cent of pre-tax income depending upon the size and composition of the household. An alternative approach to socially fair rent is that a household's rent should not exceed the amount left over after the household has paid all other necessary expenses. The alternative approaches are examined in Appendix C.

Whichever approach is used, the rent many low-income households are required to pay for their unit is more than the maximum socially fair rent for those households. To cope with those situations governments may resort to a variety of remedies. For example, shelter allowances can be paid; the rents landlords charge can be reduced by subsidizing the cost of constructing and operating units available to low income tenants. These policy alternatives are discussed in section 3.2, under the heading Budgetary Policies. As well rents themselves can be held down by regulation.

2.2 Landlords' Return On Investment

Another criterion of fair rent is that if landlords are getting a fair return on their investment they are charging fair market rents. A return generally is considered to be fair if it equals the return which could be expected on alternative investments involving similar risk.[6] The latter return is referred to as

5. If the rent a household pays is socially unfair, the household suffers an affordability problem. That issue is discussed in section 4.1.

6. This approach corresponds to the regulatory basis adopted in many regulated industries. A judicial statement on the matter is found in the reasons for judgement given by Mr. Justice Lamont of the Supreme Court of Canada in the case of Northwestern Utilities in 1979:

> The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on one hand, and which, on the other hand,

the competitive rate of return.[7] The rent level which produces a return that matches the competitive return is fair because landlords are not making high profits at the expense of their tenants in comparison with what they could make elsewhere, and tenants are not benefitting from low rents at the expense of comparatively low returns earned by their landlords on their investments.

Defining fair market rent in that way directs attention to the important practical consideration that if rents are not sufficient to generate a fair return to landlords, private investors will not be interested in investing. It must be kept in mind that what is a fair rate of return on investment is not determined by the values of tenants, landlords or government. It is determined by the terms on which investors in the market are willing to make funds available and the housing industry's demand for private investment. The former is determined by alternative opportunities in the capital markets generally. Hence, the required rate of return operates as a constraint which determines the practicability of private investment at any particular rent level.

It is easily understood that if a regulatory system is not to preclude new private investment, it must be designed so that future investors can anticipate earning a fair return on their investment. Why existing landlords must be allowed to earn a fair return is less obvious. If there are controls on demolition and conversion, existing buildings will remain in use as long as operating costs are covered, even if only a small return on investment is earned. Aside from the question of what constitutes fair treatment of existing landlords, the return allowed them may have an effect on new investment. As Quirin (1986) states:

> While it is technically true that only future investors need to be attracted, investment decisions are based on confidence in the future, and the best evidence of how future investors will be treated, once they have sunk their money into bricks and mortar, is how their predecessors have been treated. A stable mechanism for ensuring

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would secure to the Company a fair return for the capital invested. By a fair return is meant that the Company will be allowed as large a return for the capital invested in the enterprise (which will be net to the Company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the Company's enterprise.

Also see Quirin (1986, pp. 93-98). In the context of housing it is reflected in Ontario *Assured Housing for Ontario, Reforms to Rent Review*, (1985, p. 4), Clayton (1985, pp. 10-13), and Muller (1986, pp. 297-300).

7. The concept of competitive rate of return is so called because it is seen as competing as an attraction for an investors funds with the returns which can be earned in the field of rental housing. Quirin (1986, pp. 215-236) arrived at a competitive rate of return for the industry by averaging the actual returns earned on investments in a selected group of large private housing corporations. His figure (p. 224) was 17 to 19 per cent per annum as of early 1985.

> continued fair treatment will have more credibility than *ad hoc* adjustment, even if the latter is fair. (p. 62)

The Inquiry has concluded that market rents which cover all costs and leave landlords with more than a fair return are unfair to tenants, regardless of the tenants' financial position. In addition, market rents which do not afford a fair return after covering all costs are unfair to landlords and, moreover, are inadequate to ensure a private rental housing industry adequate to meet the demands of the future.

There are different rate of return calculations which can be used to provide a rate of return to compare with the competitive return. Four principal types of return are:

1. the individual building annual return,
2. the individual building long-run return,
3. the industry annual return, and
4. the industry long-run return.

In the following sections each type of return is defined and the consequences of using it as the basis for determining fair market rent within a scheme of rent regulation are examined. It is found that on a conceptual level, only the last type of return is consistent with maintaining the viability of private sector investment in the rental housing market. Use of any of the first three types will discourage private investment.

2.2.1 The Individual Building Annual Return

Some regulatory systems determine fair rents on a building-by-building basis and are designed[8] to allow landlords a predetermined return on investment for the building in each year.[9] The allowed return presumably is intended as a rough approximation of the competitive rate of return, which should result in fair rent. That approach reflects the view that rents are unfair to tenants if the actual return earned by landlords in any year exceeds the competitive rate of return and unfair to landlords if the actual return falls short of the competitive return.

8. This discussion focuses on the conceptual intent of regulatory systems. In practice, the effect may be quite different than the intent due to the difficulties inherent in measuring investment returns. The question of the desired form of regulation must be settled before addressing the practical limitations of regulation.

9. One example is the "fair net operating income" system in various jurisdictions in Massachusetts. See Adams, Ing and Pringle. (1986, pp. 71-79); another is the proposed system in Ontario. See *Assured Housing for Ontario, Reforms to Rent Review* (1985, p. 4).

However, as Muller (1986) observed in commenting on Quirin's (1986) proposed rate base-rate of return regulation:[10]

> . . . any attempt to regulate rental buildings on the basis of a ''fair rate of return'' faces very substantial difficulties. First, the majority of cases must be exempted from the detailed process and treated under a rule of thumb. Secondly, it appears to be extraordinarily difficult to design a regulatory formula which provides a ''fair rate'' of return on an annual basis and also leads to reasonable internal rate of return over the entire project. Thirdly, because they avoid negative cash flows in the early years of rental projects, most regulatory schemes lead to allowed rents in the initial years [of a new project] which are too high to be sustained in the market. Finally, the usual pattern of real rents is to fall over the life of the project in a manner which would create inequities among inhabitants of buildings of various ages and which, again, could not be sustained in the market. (pp. 209-210)

A further drawback is that if the individual building annual return is used to set rent ceilings, private investment would be discouraged. The reason relates to certain characteristics of rental housing as an investment.

Investment decisions are determined by the overall return earned during the lifetime of the investment. That return normally includes financial losses in early years, cash flow surpluses in later years, and capital gains attributable to increased land values when the property is sold.[11] A single component of the total return, such as a particular year's net income is not indicative of the overall profitability of the investment. Moreover, it is normal in the rental housing market that the income generated by a building is low in the early years of its life and high in later years.[12] As a consequence, to set rent on the basis that in each year the income should be sufficient to permit the investor to earn the competitive return would necessitate unrealizable rents for new buildings. Even if the high rents could be realized, tenants in new buildings

10. A rate base-rate of return system of rent regulation as proposed by Quirin (1986) is discussed in section 3.1.3.2.

11. Rental housing can be built on leased land but almost invariably the property will comprise the land and building. The initial land cost and the potential for appreciation in value will play an important part in decisions to acquire or dispose of the property.

12. The problem arises because accounting measures of profitability do not reflect all true economic costs, revenues and changes in the value of assets. If true economic profit could be accurately measured, there would be no systematic pattern to the rate of return earned. Also see fn 21 in Chapter 3.

would be paying much more than tenants in old buildings even if the value to tenants of these units was more or less the same. Hence, tenants would not be treated equitably since rents would reflect the relative ages of their buildings more than the relative values of their units. An added problem would be that the low rents charged as the building grew older would serve as an incentive for premature demolition.[13]

Furthermore, in a market with adequate supply it is normal that market conditions vary from year to year with the landlord earning more than a competitive return in some years and less in others. If the maximum investors in a rental property could expect to earn in any year were the competitive return, they would expect to earn less than the competitive return on average. Under these conditions, few people would be willing to invest.

Hence, the individual building's long-run return would be more appropriate than its short-run return as a test of fair rent. A regulatory system intended to be fair to both landlords and tenants should focus on the long-run average return to avoid the problems that inevitably will arise in a system which focuses on the short-run return on investment.

2.2.2 The Individual Building Long-Run Return

Using the individual building long-run return to assess the fairness of rents would avoid the problems identified above with using the short-run return. With the focus on the long-run return, if returns fall short of the competitive return in some years, they would be permitted to exceed the competitive rate of return in other years. The high return years would compensate for the low return years and allow landlords to earn an adequate return on average. Market conditions such as an unusually high vacancy rate, or excessively restrictive regulatory constraints likely to occur if inflation increases suddenly, may depress returns and necessitate a relaxation of regulatory constraints.

Although using a long-run return can eliminate some problems, others are not resolved. If the system is designed so that the competitive rate of return is the maximum return an investor can expect to earn even in the long-run, investment in rental housing will be discouraged. Investors will anticipate an inadequate return on their investment if the most they can hope to earn is the competitive rate of return while there is a risk of earning less than that return over the lifetime of their investment. To put it simply, few people will invest if the prospect of doing well is removed while the prospect of doing poorly remains.

It follows that if the individual building long-run return criterion of fairness were used to regulate rents, investment in rental housing would not be forthcoming unless landlords are guaranteed a competitive return over the life of

13. Muller (1986, p. 298).

their investments. In other words, the private rental housing sector would have to be treated as a public utility.[14] However, if that is done by passing through all costs and allowing landlords a predetermined return on investment, the primary incentive to keep costs down would be removed. It is the opportunity for an above-average return and the risk of suffering a below-average return which provides the incentive for landlords to operate their buildings cost-efficiently and to provide services which respond to the tastes and preferences of tenants as reflected in the rent they are willing to pay.

Furthermore, if the system is such that it allows all landlords to earn the competitive return, it will lead to inequities for the tenants. In an unregulated industry where the return on investment is not guaranteed, those who manage their property well by holding costs down and providing good service earn higher profits than their less conscientious or less able competitors. By and large, however, tenants will pay similar rents for similar accommodation because their rents are equalized through the operation of the market without regard for variations in the returns landlords earn. If rents are set so as to permit all landlords to earn the competitive return, the inefficient landlord would be allowed to charge higher rents than the efficient landlord. Therefore, the rents tenants pay would relate to how cost-efficient their landlord is.

The Inquiry believes it is generally preferred that the landlord, who is the investor, should bear the efficiency risk[15] associated with operating a rental complex rather than the tenant. Equity among tenants implies that the rents different households pay for similar units should be similar. Equity among tenants does not imply that their landlords' returns should be equal regardless of differences in their costs.

For the foregoing reasons, the individual building return approach is not an appropriate basis for determining whether rents being charged in the market are fair. If return on investment is to be used as the basis for determining fair market rent, attention must be directed to the average return of the industry.

2.2.3 The Industry Annual Return

If the industry return rather than the landlord's return is taken as the criterion for assessing the fairness of rent, the time frame for the industry

14. As discussed in section 3.1.3.2, rate base-rate of return regulation is a commonly used approach for regulating public utilities. In the context of housing, it attempts to set rates so that the investor will earn a pre-determined return on investment.

15. Efficiency risk is used here to refer to the risk associated with the cost of operating the building relative to the average cost of operating that type of building for all landlords. The landlord is considered to bear the efficiency risk if landlords with different operating costs for similar units collect the similar rents and earn different returns. Tenants are considered to bear the risk if they pay different rents so that their landlords earn similar returns.

return is an important factor to consider. The simplest approach would be to monitor it on a year-by-year basis. If this were done it would be necessary to recognize that an industry return above the competitive rate in any particular year should not by itself be considered evidence that rents should be restricted.

Rent levels have fluctuated and, in the absence of restrictive controls, would continue to fluctuate, between periods of short-supply and periods of over-supply. It can be expected that the return will tend to increase whenever the market tightens and decline when vacancies increase in periods of over-supply. Hence, high returns in one year are not evidence that landlords generally can expect to earn such returns over the duration of their investments. Periods of high returns are necessary as compensation for periods of low returns. Few people would be willing to invest in rental housing if high short-run industry returns are considered unfair and are denied by a scheme of rent regulation, while no compensation is provided for periods when returns in the market are exceptionally low.

Although it is inherent in any market that fluctuation in prices will occur, it may be argued that the fluctuations in the rental housing market are excessive and unnecessarily disruptive to tenants. Given the realities of the private market, some increase in rents is needed when demand exceeds supply in order to produce returns above the competitive rate and thereby to attract new investment. Moderating the price increases, however, would be beneficial. This Report contains proposals aimed at protecting tenants by stabilizing rent levels but not to the point they are so constrained that investment in rental housing is not attractive to private investors.

As demonstrated in the preceding sections, regulating rent on the basis of the return from individual buildings would involve either stifling new investment or guaranteeing all landlords the enjoyment of fair market rents. Neither alternative is acceptable and attention was directed to the industry return. Regulation on the short-term industry return basis, however, faces a similar problem of how to allow for fluctuations in market rents from year to year. Nevertheless, regulation can be employed to stabilize rent levels to moderate excessive increases while not discouraging investment but that requires using the industry long-run return.

2.2.4 The Industry Long-Run Return

If the rate of return on investment is to be regarded as the appropriate regulatory basis for the determination of fair market rent, neither the individual building short- or long-run return nor the industry short-run return is satisfactory for that purpose.

The individual building short-run return is not a true indication of the

return from a rental operation. Furthermore, if the competitive rate of return became the maximum a landlord could earn in any one year, that approach would deny landlords the benefit of rent increases which would bring the building return temporarily above the long-run return. That is needed to compensate for short-run depressed rent levels — an unavoidable occurence in a market which is not continuously in short supply.[16]

The individual building long-run return is unsatisfactory because regulation based on it would reduce the expected return in the industry to less than the competitive rate of return if the competitive rate became the maximum landlords could earn on individual buildings — with no guarantee their returns could not fall below that rate. The alternative of guaranteeing the enjoyment of the long-run building return is seen as undesirable since it would remove the incentive for landlords to control costs. Without that incentive, rents can be expected to increase, especially for the tenants of landlords who are the least cost conscious.

The industry short-run return as a regulatory basis has a defect similar to the building short-run return in that it would not allow for market fluctuations. Whether landlords are prevented from taking advantage of short-run high rents on an individual basis or on an industry basis, the effect will be that new investment will be discouraged.

Of the four possible criteria for establishing whether rents are fair, only the long-run industry return is sufficiently comprehensive to ensure the actual return realized by the industry as a whole is adequate in the long run to attract investment. If there is reason to believe that the long-run return is above the competitive level then regulation can be used to reduce the industry return to the competitive level. However, if regulation holds the long-run industry return below the competitive level it will impede new investment.

2.3 Market Competition

The third criterion for determining whether rents are fair is market competition. Economic theory suggests that unless competition is impaired, an industry cannot earn a long-run return on investment which exceeds the competitive return. As a consequence, the degree of market competition can be assessed as an alternative to attempting to measure the rental housing industry's long-run return on investment, in order to determine whether the industry is earning

16. Shortages may be experienced continuously in a market in which rents are held below the fair market rent. However, if investors are attracted into the industry, the normal cycle of shortages and surplus will inevitably occur since demand can change much more quickly than supply.

a fair return and, hence, whether rents are fair. If competition is adequate, the general rent level can be assumed to be fair.

Two commonly used indicators of the competitiveness of markets are the level of concentration and barriers to entry. Muller (1986) discusses these indicators of market competitiveness. He states:

> Two conditions are necessary if sellers in a market are to have the power to raise prices above competitive levels for a prolonged period of time. First, a small number of firms must account for a large fraction of the market and, secondly, there must be significant barriers to the entry of new firms when profits are elevated. Without the first condition, competition among existing firms will drive prices close to competitive levels. Without the second, the entry of new firms will drive prices down should incumbents firms attempt to raise them. (p. 129)

He later elaborates, saying:

> The degree to which a small number of firms account for a large fraction of the total market is called market concentration. Concentration is usually measured by the cumulative market share of a small number of largest firms. (p. 131)

and:

> The traditional barriers to entry arise from absolute cost advantages of incumbent firms over newcomers including preferred access to large sums of capital, from economies of scale which cause an efficient firm to account for a large fraction of market size, and from product differentiation which effectively restricts the size of the market available to a new entrant. (p. 132)

If investors are able to participate freely in the rental housing market, landlords will not be able to earn long-run returns which exceed the competitive rate. If investment in the rental housing industry earns a higher return than alternative investments involving similar risk, then existing landlords will want to increase their holdings by building new rental units or converting buildings from other uses. In addition, new entrants will be attracted to the industry. The result will be that supply will increase, vacancy rates will rise and rent increases will be restrained until the high returns are eliminated. Therefore, high returns can be counted on to bring about their own demise, unless natural or artificial barriers exist which block new investment. If barriers to entry exist,

it may be preferable to reduce their impact rather than to hold rents down by regulation.

Appendix D summarizes the debate concerning the competitiveness of the rental housing industry.[17] The evidence strongly supports the view that within the price and quality range which meets current housing standards, the rental housing market is highly competitive and, hence, that unregulated rents are fair market rents. Muller (1986) observes:

> concentration in the development of new apartment units . . . is well below average industrial concentration ratios in Canada. (p. 130)

He continues by stating "there are no reported estimates of concentration in the stock of rental units in Ontario." However, MMAH data demonstrate that "the share of the largest 4 or 6 [landlords] must be a relatively low percentage of the total." On the issue of barriers to entry, Muller states:

> Economies of scale are clearly not a problem, since landlords can easily enter the market at small scale through purchase or new construction. There is no evidence that large landlords have compelling cost advantages over small ones and product differentiation, while present, still allows tenants a great deal of substitution among landlords. In short, there is no evidence to suggest that barriers to entry are significant in the rental housing industry. (p. 132)

Muller completes his comments by saying:

> As a result of this review we may conclude that there are no empirical grounds to reject the basic conclusions of the competitive model because of imperfections in rental markets. (p. 133)

Notwithstanding the preceding comments, tenants appear to be concerned about the possibility of sudden, sharp rent increases as market conditions change. Whether that possibility is real or imagined, a regulatory system which provides assurance that rents will increase with costs in an orderly fashion, even when vacancy rates are low, will be attractive to tenants. Given the importance of rent in the personal finances of most tenants and the slow rate of adjustment when the market demand and supply are out of balance, the

17. Also see Appendix E which reviews the evidence on the question of the industry's return on investment.

prejudicial consequences of this phenomenon for both landlords and tenants[18] — although not for both at the same time — may be severe. It should be noted that the speed of adjustment is determined not only by characteristics of the market but also by actions of government which speed or slow the approval process for new construction and by budgetary programs such as tax benefits, which increase or decrease the attractiveness of investment in rental housing. Whatever the source of impediments to a rapid response to the swings in the market, they detract from the effectiveness of market competition as a criterion of fairness.[19] The relevant question is whether the fluctuations can be modified by regulation without superseding the market entirely. That issue is addressed in section 4.3.

2.4. Concluding Comments

Two concepts of fair rent are relevant to the Inquiry's analysis. One is the concept of socially fair rent which is the rent a household can afford to pay for adequate accommodation. The maximum socially fair rent for a household or to put it another way — its socially fair rent limit — reflects social values as embodied in public policy. The other concept is fair market rent which is the minimum rent level which will provide landlords with a return on their aggregate investment in rental housing sufficient to retain existing investment and attract new investment.[20] Given that rent level, all landlords who manage their properties efficiently will be able to cover their operating and debt costs, and have sufficient net income left over to provide them with the competitive rate of return on their investments.

For most households their socially fair rent limit is above the current market rent for the rental accommodation occupied by them. The Inquiry is

18. In discussion of rent regulation, attention tends to focus on periods of undersupply and rent increases; however, stability in the market involves controlling both periods of undersupply and oversupply.

19. Infrequent and isolated instances of gouging, which is discussed in section 4.2.1 and economic eviction, which is discussed in section 4.2.2, are not regarded as indicative of inadequacy of market competition as a criterion of fairness. They are offensive behavior on the part of particular landlords and not inherent in the normal market. As such they should be dealt with as special situations. See the discussion of the single building review mechanism of the FMR system in section 5.4.

20. In this Report, fair market rent level refers to a general level of rents which is sufficient for the industry to earn a fair return. Hence, the average rent level equals average costs which consist of operating, debt and equity costs. In addition, the general level of rents for any identifiable type of rental unit reflects the average cost associated with that type of unit. The rent for a particular unit is a fair market rent if the average market rent is at the fair market rent level for that type of unit.

not aware of any criterion of fairness which calls for benefits being extended to those households in the form of lower than fair market rents or subsidized housing at the expense of either landlords or taxpayers generally. For those tenants both criteria of fairness, that is to say socially fair rent and fair market rent, can be satisfied by a policy designed to ensure that the actual rent charged is at the fair market rent level.

The socially fair rent limit for many low income households is less than the fair market rent for adequate housing. In that event no rent level, whether determined by the market or by regulation, will satisfy both concepts of fairness. Rent regulation in its present form of holding rents below market levels is a compromise. While satisfying neither of the fairness criteria, it imposes unjustified financial losses on landlords, provides inadequate relief to low-income tenants and has deleterious effects on the rental housing stock. Furthermore, the amount of relief provided to tenants is not related to need; hence much of the assistance is misdirected.[21]

While such a policy is popular with those who benefit from the misdirected assistance, policies aimed at those in need — which also deny such aid to the majority who do not require financial assistance — are clearly preferable from a social perspective and are advocated by this Report. Social assistance should be the responsibility of taxpayers generally so that the burden can be distributed equitably throughout society on the basis of income. A policy which affords only partial relief to those in need and yet is wholly at the expense of one class in the community, namely landlords, is not acceptable. At the same time, all tenants should be protected against excessively high rents and to that end the income of the rental housing industry should be regulated if it is excessive in comparison to what can be earned in comparable investment opportunities in the absence of regulation.

The Inquiry also takes the position that fairness to tenants, whether or not they need social assistance, requires that they be assured actual market rents do not exceed fair market rents.[22] The criterion for fair market rent is that the long-run industry return reflects the long-run competitive rate of return. That criterion is used since it is necessary to balance the interests of tenants against the interests of landlords and to maintain a healthy climate for private investment. Fairness to landlords requires that the regulatory system does not deny them the opportunity to earn the competitive rate of return on their

21. The consequences of providing assistance to tenants by holding rents down is discussed more fully in the discussion of restrictive regulation in section 3.1.1.1.

22. The discussion in Chapter 4 actually goes a step further. Not only should the long-run industry return not be excessive, but the short-run industry return should be reasonably stable. It would be little consolation to tenants to be assured that everything will even out in the long-run, if their rents today are excessively high relative to the legitimate costs of landlords.

investments. The long-run return of the industry is the only appropriate indicator of the adequacy of the return. A regulatory system which limits rents by reference to either the short-run industry return or the returns of individual landlords will fail to maintain a healthy investment climate, since in either case the return landlords can expect will be less than the required return.

Flaws in a system which regulates short-run returns may create opportunities for the industry to achieve the competitive rate of return in the long run. However, unless the long-run industry return is explicitly considered, there is no way of determining how fairly landlords and tenants are being treated by the system in general. As a consequence, there is a high risk the system will discourage necessary investment in rental housing.

Furthermore, any regulatory system which does not explicitly consider the rate of return being earned, will have an inconsistent effect across the rental housing market. As a consequence, the risk of investing in rental housing will be increased and higher anticipated returns will be required to attract investment than would be required in the absence of regulation. That is not in the interest of tenants.

A further dimension of fairness is that rents for similar units in terms of size, location and other features should be similar. Both landlords and tenants see a measure of inequity when different rents are paid for units of similar value.[23] A regulatory system which sets rents on the basis of the costs of individual landlords will not necessarily mean that landlords are being treated equitably and will result in rents which treat tenants inequitably.

Not only is variation in the returns earned by landlords a normal characteristic of the market, it is essential to maintaining an incentive for landlords to operate their buildings in a cost-efficient manner. As a consequence, differences among the returns of landlords helps to keep average rent charges down.

The key point which emerges from the analysis in this Chapter is that the traditional focus of rent regulation, which is to set rents by reference to costs on an individual building basis, is not acceptable either as a practical means of maintaining a healthy investment environment or a means of achieving a balance of fairness between landlords and tenants. An alternative approach to determining a fair market rent is needed. It should have two steps. The first should be to determine the fair market rent level for the market as a whole based on the industry's long-run rate of return on investment. The second step

23. In fact, regulation in other industries is commonly used in part to effect some degree of cross-subsidization to reduce price differentials even when the cost of serving different clients differs substantially.

should be to make provision for similar rents being charged for similar units, so that the rents for individual units generally would be in line with the overall fair market rent level. A regulatory system for achieving fair market rents throughout the industry is described in Chapter 5.

Chapter 3

Types of Residential Tenancy Programs

The purpose of this Chapter is to analyze existing types of housing programs. Consideration is given to Ontario's existing rent regulation program and those of other jurisdictions[1] as well as conceptual approaches to rent regulation. Chapter 4 examines problems in the rental tenancy market and the suitability of the different types of housing programs to resolve or alleviate those problems. Chapter 5 outlines a system of rent regulation which takes a radically different approach to the regulatory process to devise a system which would set rents based on the principle of fair market rent.

Chant (1986) in the introductory comment to his Research Study refers to the "maze of housing policies."[2] In discussing types of housing programs, he says:

> For present purposes, rental housing policies can be classified according to their initial impact on the housing market.
>
> Four 'generic' types of rental housing are distinguished:
>
> 1) *Market augmenting* policies work through influencing the behaviour of private market participants (i.e., tenants or private landlords or both) under a given set of market conditions and institutions.

1. While it is not feasible, within the confines of this Report, to describe all programs, Adams, Ing, Ortved and Park (1986) present in outline form the systems of rent regulation functioning in the provinces of Canada, Great Britain, a number of jurisdictions in the United States, several European countries and in Australia and Hong Kong. The study was prepared by the research staff of the Inquiry and is essential reading for an understanding of the many ways in which rent regulation has been approached in different jurisdictions.

2. The terms policy and programs are not used interchangeably in this Report. Programs refer to specific initiatives which implement more general policy.

> 2) *Market replacing* policies work through influencing some third party other than private landlords (i.e., either government, its agencies, or non-profit participants in the housing market) to supply rental housing.
>
> 3) *Rent regulating* policies serve to alter the market outcome from that which would have occurred, given the existing demand from tenants and existing supply from landlords.
>
> 4) *Institutional* policies alter the arrangements which govern the actions of market participation in either the supply of housing or in the terms of transactions between tenants and landlords. (p.89)

This chapter follows Chant's classification. Section 3.1 examines regulatory policies under the heading Rent Regulation. Section 3.2 discusses the various types of budgetary programs; Chant (1986) uses the term budgetary policies (or programs) to cover both market augmenting and market replacing programs. Market augmenting programs are further separated into demand, supply and combined programs. Institutional policies are dealt with in section 3.3.

Rent regulation, budgetary programs and institutional programs are not mutually exclusive and an effective residential tenancy policy must bring all of them into play. While they do not have the same objectives, together they make up a comprehensive approach for ensuring that suitable rental housing will be reasonably available for all who need or desire it at rents in keeping with their economic condition and not subject to extreme or disruptive increases.

3.1 Rent Regulation

In the final analysis, to regulate rent is to limit the amount of rent which can be charged. In pursuing that end, rent regulation can take different forms. Two aspects of rent regulation systems require particular attention: 1. whether the effect of regulation is restrictive or moderate; 2. whether landlords and tenants must use the mechanisms of the regulatory system or have the option of negotiating agreements privately. Those features of rent regulation systems are discussed below in sections 3.1.1 and 3.1.2, respectively. It is also important to differentiate between rent regulation systems which take the form of rent review and rent control or a combination of both. Section 3.1.3 examines three conceptually distinct types of rent review: cost pass-through, rate base-rate of return and market comparison. Section 3.1.4 examines rent control.

3.1.1 Restrictive or Moderate Regulation

Restrictive regulation in the understanding of the Inquiry is regulation which reduces rents and keeps them below the fair market rent level. Moderate

regulation may reduce rents to the fair market rent level but does not reduce them further. The distinction between restrictive and moderate regulation is important since their effects are markedly different in that, under a moderate scheme of rent regulation, private investors are able to earn the competitive rate of return on their investments.[3]

3.1.1.1 Restrictive Regulation

Any regulatory scheme which holds rents below the fair market rent level is labelled restrictive but, in practice, there are varying degree of restrictiveness. The circumstances of individual landlords and tenants differ so much that a universal system may be highly restrictive for some while being far less restrictive or even moderate for others. Also a system which is restrictive in design may in effect be moderate in result for those who are willing and able to circumvent either the spirit or letter of the scheme. The number of loopholes, the sophistication required to make use of them and the level of enforcement will affect the restrictiveness of the scheme.

It follows from the discussion in Chapter 2 that a restrictive scheme of regulation treats landlords inequitably relative to investors in other industries. Furthermore, while a restrictive scheme may be attractive to tenants in the short run since those who live in rent-regulated units pay less than fair market rent for their apartments, the effect of low investment returns on the supply of rental housing is a serious concern. A decline in supply is the inevitable consequence. Existing landlords will have an incentive to renovate, convert or demolish their buildings in order to increase the income generated by their property. New investors simply will not invest in rental housing if they expect their returns will be restricted to less than the competitive rate of return. Even if the system exempts new construction, investors will develop rental housing only if the rents they can expect to collect are high enough to offset the risk that political intervention will restrict those rents in the future.[4] As a consequence, the rent level for new supply will be higher under a restrictive regulatory scheme than under a moderate scheme.[5] It is evident that the more restrictive regulation is, the more severe will be its impact on the supply of rental housing.

3. Stanbury and Vertinsky (1986) discuss this topic in detail under the heading Moderate Versus Restrictive Rent Controls. (pp. 7-17 to 7-33)

4. The effect of political risk is discussed more fully in section 3.2.

5. The disincentive can be overcome if the government provides subsidies sufficient to compensate for the political risk. However, doing so simply transfers the increased cost of attracting private investment into the rental housing industry from the tenants of the new buildings to taxpayers.

The only circumstances in which restrictive rent regulation would appear to the Inquiry to be justifiable are extra-ordinary situations which call for temporary emergency measures. For example, in wartime, a restrictive regulatory scheme or even a rent freeze may be warranted as part of a widespread price control mechanism.[6] Even in that extreme situation, however, it is far from clear whether rent regulation should hold rents below the level necessary for the industry to earn a fair return, or simply moderate the effects of housing shortages and ensure that excess profits are not earned.

Restrictive regulation also may be justified as part of an overall anti-inflation program, such as that introduced in Canada in 1975. Many groups in society were called on then, as in wartime, to accept financial sacrifices in the short-run in order to achieve the goal of slowing inflation. But if rent regulation extends beyond a period of two or three years, the rate of rent increase must be enough to cover increasing costs and maintain the necessary return on equity if private sector investment is to be maintained. Restrictive regulation as anything more than a temporary measure is not compatible with maintaining an adequate supply of privately financed rental housing. The reasons are dealt with in detail under the heading Availability of Capital in section 4.8.

Although restrictive regulation may appear to be beneficial to tenants, it has damaging effects after a few years. As the vacancy rate falls, the likelihood of unconscionable increases is enhanced greatly, regardless of the limits imposed by the regulatory system. Tenants who are seeking a place to live are often willing to strike private deals with landlords, building managers or other tenants who are attempting to circumvent the system, since doing so may be the only way to get a desirable unit. It is the wealthier tenants who fare best under those conditions.

A final observation is that regulation undertaken for the purpose of reducing rents to a fair market level is not restrictive.

3.1.1.2 Moderate Regulation

A moderate regulatory system is designed to allow landlords to earn the competitive rate of return on their investments while limiting opportunities for rents to rise above the fair market level.

The argument for moderate controls is put by Stanbury and Vertinsky (1986) as being:

6. In a wartime economy the competitive rate of return could become exceptionally high in the absence of price controls. The shortages which would tend to cause prices to increase drastically are not indicative of allocational inefficiency because the price mechanism is overridden by the demands of the war effort.

> . . . that it is desirable to regulate the relationship between tenants and landlords in such a way as to provide tenants with protection from the extreme vagaries of the rental housing market . . . The aim is an equitable relationship between tenants and landlords, and to minimize the abuses associated with sellers' market power during periods of excess demand, yet at the same time to minimize the misallocation of resources associated with [restrictive] price controls. (p. 7-23)

The limited role of moderate rent regulation has been put this way by Gilderbloom and Appelbaum (1984):

> In attempting to avoid problems traditionally associated with restrictive controls, moderate controls also may fail to provide across-the-board general rent relief for tenants, rather working mostly to control extreme or erratic rent increases. In other words moderate rent controls may often provide protection against rent gouging but will not affect those tenants whose landlords are earning a fair and reasonable return on investment. (p.6)

Stanbury and Vertinsky (1986) note various factors which distinguish moderate from restrictive rent regulation. The leading characteristic of a moderate control system mentioned first is that "excessive rent increases are prevented while allowing landlords to earn a 'fair and reasonable' return" (p. 7-17). They suggest several alternatives ". . . which could be considered to bring about a truly 'moderate' system of rent controls." (p. 7-50) The first is "a decentralized voluntary system with a centralized binding dispute resolution mechanism." (p. 7-50) That is essentially the present Quebec system discussed in section 3.1.2 below. The second alternative is "an index-based, automatically adjusting rent ceiling with an option for individual review to see if normal rates of return on investment are being earned." (p. 7-50) In describing this scheme Stanbury and Vertinsky (1986) say:

> To achieve the objective of maintaining a normal rate of return on investment in rental properties, the general statutory increase should provide for average increases in costs *as well as* increases in the net income needed to maintain a normal rate of return on invested capital. . . . since the stock of housing is not homogeneous, the option of rent review for an individual building is available to landlords whose units experience significantly different increases in costs than the one reflected in the indexes used to calculate the general adjustment (guideline rate). Tenants may use it to ensure that land-

> lords do not adjust the quantity of services in order to increase their profits as well as to ensure that they pass through any *reduction* in operating costs. (p. 7-45)

This approach corresponds to the rate base-rate of return system which Quirin (1986) elaborates in some detail. See section 3.1.3.2.1.

The practical problem in designing a moderate regulatory system is to settle on a test or criterion for determining when rents generally are at a fair market level. The rate base-rate of return calculation described below in section 3.1.3.2 is the only method known to the Inquiry for determining whether rents are at the fair market level. Moreover, the rate base-rate of return technique can be applied to landlords as a class or to categories of landlords identified by location and the type, size and quality of their properties to determine the gap between the actual and fair market rent levels. The usefulness of that technique would depend upon the validity of the data used for determining the fair market rent level. The Fair Market Rent system described in Chapter 5 utilizes this approach. A rate base-rate of return calculation can be employed to determine whether rents are adequate to yield a fair return on investment. It was shown in Chapter 2 that fair market rent cannot be determined on an individual building or individual landlord basis.

In designing a moderate regulatory system, the risks associated with underestimating and overestimating the true fair market rent level must be taken into account. If the fair market rent level is underestimated, the system in fact will be restrictive. Rents in general will fall below the fair market rent level, returns will fall below the competitive level and investment will be discouraged. The litany of effects discussed elsewhere in this Report inevitably will follow, with their severity depending on the gap between the true fair market and the actual rent levels.

On the other hand, if the fair market rent level is overestimated and a high guideline rate is allowed by the rent control system, market competition will tend to make it difficult for landlords to realize the full increases permitted by the control system. Nevertheless, to the extent that competition is imperfect, the industry may earn rates of return above the competitive return, particularly in the short-run. A high return will tend to attract additional capital to the industry leading to an increased supply of rental housing which would put downward pressure on rents.

The social costs of underestimating the fair market rent level are more severe than the social costs of overestimating the level. Low vacancy rates, delayed maintenance, demolition and conversion, and other consequences of low rents cause inconvenience and hardship for many tenants. Rents which are a little on the high side will have the effect of ensuring that the supply of housing is adequate to meet demand and, if assistance is available to households

with an affordability problem, those rents will create minimal hardship. Furthermore, investment will be attracted and vacancy rates increased. Tenants will have increased choice and find it relatively easy to find suitable accommodation at a fair market price.

3.1.2 Mandatory or Optional Regulation

Systems of rent regulation can be mandatory or optional. Rent regulation is optional if the rent can be set by consent between a landlord and tenant without reference to the amount which would be allowed under a formal regulatory mechanism. If the system is mandatory, landlords cannot charge more than a statutory or calculated amount over a prescribed period even if the tenant agrees to a higher rent. Rent regulation in Ontario is mandatory in that under sections 67 and 68 of the 1986 Act (formerly sections 124 and 125 of the 1979 Act), a landlord can charge only one rent increase every 12 months which cannot exceed a prescribed limit. A more frequent increase or one greater than the limit was "illegal" under the 1979 Act (see the marginal note to section 129 of that Act) and under the 1986 Act, the landlord will be exposed to prosecution (see clauses 118(1)(c)(d)(e)). Under an optional system, the frequency of a rent increase may be restricted but the landlord and tenant can negotiate[7] an increased rent they agree is fair which then becomes the legal rent. The regulatory feature of an optional system is that if the parties cannot agree on a rent increase, the matter goes to the regulatory authority for disposition.

It is a feature of an optional system that a landlord is free to charge an incoming tenant the market rent notwithstanding that the previous tenant had been paying a lesser controlled amount. (The new tenant will have the benefit of any protection available under rent regulation in respect to subsequent increases). The practice is known as vacancy decontrol and may be recognized formally or simply tolerated by the regulatory authority. Even if there is no formal policy of vacancy decontrol, an optional system of rent regulation will tend to decontrol rents when there are vacancies. The practice of vacancy decontrol raises the difficult question of whether departing tenants should be denied the right to assign or sublet their leases. If they had this right, landlords' opportunities to charge vacancy decontrol market rents would be curtailed

7. It is stated in Volume 1, p. 196, of this Report that in the opinion of the Inquiry, negotiated rent arrangements between landlords and tenants are incompatible with the scheme of controlled rents under Part XI of the Residential Tenancies Act. That comment was made in the context of specific sections of Part XI of the 1979 Act which dealt with the mediation process conducted by the Residential Tenancy Commission regarding alleged payments of illegal rent increases. The discussion of negotiation in this section of the Report examines the role of negotiation in rent regulation systems generally.

greatly while tenants would be free to sublet at increased rents or charge for assignments of their leases.

If a regulatory system is intended to take the place of the market as the method for setting rents or rent increases, it should be mandatory in form.[8] It would be a contradiction in terms to allow a landlord and tenant to agree on a rent or a rent increase which would violate the intended constraints of the system. However, not all regulatory systems are intended to replace the market. Some are intended simply to improve the tenants' bargaining position and to resolve disputes. Negotiation is a necessary part of such regulatory systems. Furthermore, there are practical reasons for allowing and in fact encouraging negotiation in the initial stage of the process even though the regulatory process will take over if the parties cannot agree.

To illustrate the part that negotiation can play as an element in an optional system of rent regulation, it is instructive to consider the situation as it is in Quebec and as it was in Manitoba for a period of time.

The approach of the Quebec system, which is administered by the Régie du logement, is discussed by des Rosiers (1985):

> The basic philosophy . . . of the Régie rests upon the principle that harmonious relationships between landlords and tenants will emerge from better information on their respective rights and duties and that, where this cannot be achieved, the Régie will help them settle their disputes in a fair and just manner and in the best possible atmosphere.
>
> . . . the Régie is actually a tribunal with the double mandate of deciding on claims submitted to it and, where possible, bringing landlords and tenants together. It should be stressed that the mandate of the Régie is not to set rent universally or globally, but to favour above all negotiation and private settlement between the two parties.
>
> Consequently, it intervenes only in a limited number of cases accounting for between 5 percent and 10 percent of the rental market and operates on a case by case basis; even then, only a fraction of claims presented before the Régie will actually be settled through a decision by the tribunal. (p. 7)

If the landlord and tenant cannot agree on a proposed rent increase, the landlord may apply to the Régie. The Régie annually publishes a form to be used by landlords to calculate an approximate rent increase for their building.

8. In terms of the issues identified in Chapter 4, a general reduction of the rent level may be needed in the short-run to limit market fluctuations or in the long-run to stop the industry from earning excess profits, if it is shown that excess profits are earned in the absence of regulation.

It permits the parties to work out for themselves what might be allowed on an application to the Régie. A statement of the purpose of the form reads:

> The purpose of this form is to help tenants and landlords negotiate a reasonable rent increase using a method suggested herein. Essentially, it is a basis for **approximate** calculation which takes economic factors into account and enables the parties to examine the situation as realistically as possible. Those using the method will gain some insight into how the Régie du logement itself goes about setting a rent when requested to do so.
>
> The Régie takes only objective and quantifiable data into account in its decisions. Nevertheless, there are other factors, especially those of a qualitative kind, which the parties may wish to consider when negotiating an agreement. It is up to them to assess any such factors according to their own needs, and decide on the degree of importance they attach to them.
>
> Real negotiation involves an exchange of relevant information between the tenant and the landlord. The landlord must provide the tenant with facts and figures about the building, and the tenant must try and examine them in good faith. If, as a last resort, the Régie du logement is asked to decide on the case, it will require this same data to be produced, along with supporting documents, in order to assess the situation with complete objectivity.

Subject to any revision of the data at the hearing before the Régie and to any special feature of a particular case, the increases ordered by the Régie reflect the increases projected in the calculation form based on stipulated percentage increases for each cost category.

The Quebec system serves two roles ancillary to the normal market process. First, it provides information to both landlords and tenants as to what generally would be considered a fair increase given current economic conditions. Second, it provides tenants with a way of defending themselves against excessive rent charges.[9] If negotiation with the landlord does not resolve the difference of opinion, the tenant is not left in the position of either having to pay the increase or vacate the premises.

The great merit of the Quebec system is that the participants can work out for themselves the probable outcome of an appeal to the Régie should the matter get to that stage. Therefore, negotiations which precede that point are accordingly constrained. Either party would have to have a convincing reason

9. See the discussion of excessive rent charges in section 4.2.

to persuade the other to accept a rent increase significantly different from that which would be allowed by the Régie. The indication to the Inquiry was that deviations from the increase which would be approved by the Régie on the basis of the calculation form were rare. The regulatory process moderates the market process without removing the freedom to come to an agreement which both the landlords and tenants consider reasonable. Furthermore, since the stipulated percentages are determined on an annual basis and reflect changes in the operating and financing costs of the industry, the increase allowed approximates the rate of change in the fair market rent level for the Quebec rental housing market. As a consequence, the system is moderate rather than restrictive.[10]

A tenant advocate in Montreal, however, told the Inquiry that some tenants agree to increases proposed by their landlords which are greater than the amount they could expect the Régie to allow. He said many tenants do not want to be involved in a formal and complicated review process, do not want to start a fight with their landlords, do not know their rights, or may be intimidated or frightened.[11]

Yet, according to documentation provided by Stanbury and Vertinsky (1986), the stereotype of the money-grabbing landlord — forever trying to pry more money from his vulnerable tenants — is often far from the truth. Speaking of the situation in Ontario, they said:

> . . . about an average of 23% of the controlled units did not experience a rent increase in any particular year fom 1977/78 to 1980/81. As we document . . . it is mainly non-movers that receive this benefit. (p. 6-5)

They later elaborate:

> The data . . . also indicate that, regardless of the size of the building, a substantial fraction (about one-third) of tenants did not experience an increase in rent when (i) vacancy rates were low or very low, (ii) the legally allowable increase without rent review was 6%, and (iii) the general rate of inflation was between 8% and 12%. (p. 6-133)

10. Allowing negotiation does not ensure that a regulatory system will be moderate. Because the existence of the regulatory process constrains negotiations, a system which makes provision for rent increases which are less than the rate of increase in the fair market rent level will tend to be restrictive. Negotiation will ease the restrictiveness of the system but in a manner which is not consistent throughout the market.

11. Evidence of Claude Dagneau, Oct. 29, 1985, Transcript 122-2, p. 56.

Negotiation is a two-way process which may on some occasions favor landlords and on other occasions favor tenants, even if it generally results in a rent which approximates the rent which would be allowed by the formal review process.

Joseph Locke, the Manitoba Rentalsman, gave evidence regarding the experience in Manitoba with negotiation.[12] In Manitoba the law as it stood from 1980 to 1982 provided that the Rentalsman could mediate on the request of either the landlord or tenant and failing a satisfactory resolution, the matter was referred to the Director of Arbitration.[13]

The witness reported that the mediation/arbitration approach had functioned satisfactorily. The reversion to a rent control system in 1982 reflected a change in the philosophy of government rather than dissatisfaction with mediation. Under mediation the parties were able to agree on the amount of rent increase in the majority of the cases brought before the Rentalsman or his staff. Consent to arbitration took the form of not objecting within a stated period following notice that arbitration would follow. The tenor of the evidence was that in one way or another binding arbitration was the inevitable aftermath of failed mediation.

The Manitoba system was less interventionist than the Quebec system since it did not provide published criteria or guidelines which allowed the parties to determine in advance what would be allowed by the Rentalsman. Essentially it sought to get the parties to reach an agreement within the context of market conditions and provided a mechanism for dispute resolution.

Optional regulation as practised in Quebec, and in Manitoba for a period of time, may be justified for several reasons. One is that it is administratively simpler to have the parties come to an agreement than to require the parties to go through a hearing in all cases where the guideline increase is considered to be inadequate. Private agreements would not undermine the regulatory system because they would be constrained by the review process used to resolve disputes. There is much to be said for that approach. Also, if a rent increase is negotiated, it would be akin to market rent and hence a fair rent unless there are circumstances which give rise to the problem of excess profits. Even if this is subject to some reservation, negotiation and mediation[14] when voluntarily undertaken and properly conducted, in many cases would soften the acerbities of the landlord-tenant relationship and expedite the rent setting process.

12. Transcript 64, Aug. 2, 1983, pp. 100-137.

13. See Manitoba Regulation L70-M.R. 183/80, section 8.

14. The Inquiry does not perceive any fundamental difference between negotiation and mediation. The former ordinarily would take place outside the regulatory structure altogether. The latter would be a part of the process in that it would be conducted by an administrative official. It should not be part of the mediation process to pressure the parties to come to an agreement.

A system of rent regulation which is optional is based on the view that landlords and tenants in general, under the auspices of a regulatory body, can determine a fair rent. The regulatory system then serves to supplement, rather than to replace the market, in two ways. First, it provides a reference standard so that both parties have some official indication of what constitutes a reasonable rent charge or rent increase, although individual circumstances may warrant deviations from that norm. Second, the regulatory system provides a way of resolving disputes when a landlord and tenant cannot agree.

3.1.3 Rent Review

Rent review is an administrative process whereby rents or rent increases, for particular tenancies taken individually or grouped as all the tenancies in a complex, are determined by a government official or tribunal. It must be distinguished from rent control which takes the form of a ceiling or limit on rent increases uniformly applied by legislation or regulation to all tenancies or to all of a class of tenancies. It is examined in section 3.1.4.

It is administratively feasible to have a pure rent control system of universal application with no accompanying review feature. It is not feasible however to have a rent review system under which the rents for every tenancy complex would be set on an individual basis. The administrative dimension of such an operation would be horrendous. For that reason, if for no other, review systems are accompanied by control systems or some other mechanism such as negotiation whereby the bulk of rent increases are set without recourse to the review process.

Rent review itself may take many forms differing in important respects. The cost pass-through, rate base-rate of return, and market comparison systems are examined in the next three sections.

3.1.3.1 Cost Pass-Through

The cost pass-through approach to rent review ties the rent increase permitted a residential complex to operating and financing cost increases. Ontario's cost pass-through system of rent review under the 1979 Act is examined in detail in Volume 1 of this Report. It did not take into account whether the landlord was earning a return on equity and if so how it compared with the return which could be earned on other investments of similar risk. Volume 1 states:

> The real issue at stake is the adequacy of the landlord's return on equity. (p. 115)

> [However] because the 1979 Act does not regulate rents by reference to the landlord's return on equity,[15] the matter did not fall within the scope of the first phase of the Inquiry. (p. 114)

All other aspects of cost pass-through, namely the issues related to the pass-through of operating costs and debt financing are covered in Volume 1.[16] Further comment is required on the issue of the pass-through of costs associated with equity financing.

A comprehensive cost pass-through system would ascertain the change in the cost of equity financing and incorporate that into the allowed rent increase, along with changes in operating costs and debt financing. The Quebec system attempts to do that by means of what is called an "adjustment of net income." It is a percentage of the existing net income; net income being calculated by subtracting operating costs and debt interest from the current rental income. The percentage adjustment is set annually in an obscure manner by the administration. According to des Rosiers (1985), it is related to fluctuations in the interest rate combined with building value appreciation.[17] It is never a negative percentage even when the mortgage rates have fallen sharply.

The justification advanced for the cost pass-through system of rent regulation is that it is equitable for both landlords and tenants: landlords cannot increase rents by more than their cost increases and tenants suffer rent increases only to the same extent. The argument is faulty for five reasons.[18]

First, an essential feature of a cost pass-through system is that the review process determines the rate of increase in rents without reference to the amount of those rents. This approach assumes that all base year rents are fair. That is not the case. The actual base rent in some cases is above and in other cases below the fair market rent. There are many reasons why rents are not at the fair market level.

15. There was no equity factor in the Ontario rent review scheme as it operated between 1975 and 1986. In 1979, provision was made for a two per cent hardship allowance if rents did not meet operating and financing costs. There was no link between that allowance and the landlords' return on the equity in the investment so that, although it would have been helpful for some landlords, it did not deal directly with the return on equity problem.

16. Depreciation of pre-1975 assets is not considered by the current system. However, if straight-line depreciation is assumed, then there would be no changes in the depreciation expense to be considered on a cost pass-through basis except at the end of the depreciable life of relevant assets. Depreciation of capital expenditures is allowed in the form of the allowance for capital expenditures.

17. Des Rosiers (1985, p. 26 et seq) provides a detailed explanation of the calculation.

18. The five reasons follow from the discussion of fair market rent in Chapter 2.

After 11 years of a cost pass-through system, rents inevitably will have deviated significantly from the fair market rent. Even small imperfections in the pass-through mechanism which cause the allowed increase to deviate from the actual change in the fair market rent level can result in cumulative deviations from the fair market rent level which are quite large. Furthermore, many instances of deviations from the fair market rent date back to 1975 when the regulatory system was first introduced. In some cases rents were depressed because of local market conditions.[19]

In other cases, long standing tenants had received tenure discounts[20] and their rents were below the 1975 market levels. In still other cases, landlords had been able to push their rents above the fair market level due to local market conditions. Some have undoubtedly maintained their rents at relatively high levels, especially if they took full advantage of the review mechanism. Whatever the reason, landlords and tenants have had no opportunity to bring the rents back to normal since costs are passed through without determining whether the base rent is above or below the fair market rent level.

Second, to be willing to invest, a landlord must expect to earn a fair return over the life of the investment. It is a characteristic of the rental housing market that in the early years of a new complex the annual return is low when measured using generally accepted accounting principles. In fact, both the cash flow and the net income are normally negative for several years. Over the years rents tend to increase more rapidly than operating costs; hence, the annual return increases. If the rents are locked in at the level being earned in the early years, the return over the life of the investment will be inadequate.[21]

The third reason is that fairness to landlords does not require rent increases to reflect the increased operating costs on an individual building basis. The discussion of fair market rent in Chapter 2 showed that rent increases need

19. Subsection 134(3) of the 1979 Act gave a landlord the right, subject to restrictive conditions, to increase without an order rents which had been depressed due to economic conditions.

20. For a discussion of tenure discounts see Steele and Miron (1984, p. 24).

21. The problem is actually one of practicability given the limitations of accounting data. Accounting income does not include changes in the value of net equity in the form of unrealized capital gains from appreciation and losses through capital depreciation. If they were considered, the expected measured return would change in early years. For example, since a capital gain is implicitly reinvested because it is not realized, the accounting rate of return in later years would be decreased since the equity base would be greater. In theory, the economic rate of return each year is expected to equal the competitive rate of return. In practice, determining the landlord's true economic return is virtually impossible since the ultimate capital gain or loss which will be realized on a property cannot be predicted. As a consequence, real world regulatory systems normally use accounting measures of income, resulting in the problem described.

only reflect increases in industry costs in general, not individual building cost increases.

A fourth problem with the cost pass-through approach is that it reduces the incentive to landlords to operate their buildings efficiently. Costs and therefore rents are likely to increase unnecessarily. To make matters worse, a cost pass-through system actually encourages landlords to incur unnecessary and perhaps even artificial costs when tight markets and a low vacancy rate afford them the opportunity to raise rents. For example, a purchaser may incur excessive financing costs in the purchase of a rental property which can be passed through to the tenants, thereby raising rents indefinitely, although the originally excessive costs may be eliminated later.

The final reason relates to the principle of fairness that tenants in similar units should pay a similar rent. A cost pass-through system makes no pretence of equalizing rents among buildings which have different costs but offer the same value to their tenants. Many tenants may feel that rents should reflect value rather than cost, as they do in an unregulated market. The inefficient landlord should bear the cost associated with inefficiency, not the tenants. Conversely, the efficient landlord should be rewarded by being permitted to earn a better than normal profit.

For those reasons, a cost pass-through system of rent review cannot set rents which are fair market rents as defined in Chapter 2. To determine fair market rents, it is necessary: 1. to consider explicitly the industry's return on equity; and 2. to base all rent increases on the rate of increase in the costs of the industry generally rather than on the increase in costs for individual buildings.

At best, cost pass-through can be seen as a safety or blow-off valve which can moderate, to some extent, an otherwise restrictive system of rent control. It may be that this was the intention of those who devised the Ontario system in the first instance and the system may have been adequate as a temporary system of rent regulation. In the long-run, a restrictive system of rent control, even if it is moderated by a cost pass-through review system, will not give rise to an equitable regulatory scheme or a rental market which is attractive to private investors.

3.1.3.2 Rate Base-Rate of Return[22]

The first two of the five problems noted above associated with cost pass-through systems of rent regulation can be avoided by utilizing a rate base-rate

22. The discussion of the rate base-rate of return approach to regulation contained in this section is much more extensive than the discussions of other types of regulation. This special attention is needed because the rate base-rate of return approach serves as the conceptual basis for the Fair Market Rent system. It should be noted, however, that FMR actually adopts the rate

of return system which determines allowed rents rather than allowed rent increases. That approach to rent regulation would take into account the fairness of the initial rent level as well as the amount of the increase. It also avoids the related problem of landlord's returns being "locked-in" at levels which are either high or low relative to the competitive rate of return.

The rate base-rate of return approach to regulation is based on the principle that each landlord should earn the competitive rate of return on his investment. However, since it focuses on the individual building return, the approach does not ensure that the rents charged are fair market rents as defined in Chapter 2.[23] Nevertheless, the rate base-rate of return approach merits careful examination. As is shown in section 3.1.4 below, the basic concept can be utilized on an industry-wide basis to determine the fair market rent level.

In Quirin (1986), a survey of the price-setting mechanisms used in other regulated industries shows that the most comprehensive form of a cost-based system of regulation is rate base-rate of return (or cost-of-service) regulation. Quirin observes that the distinguishing feature of rate base-rate of return:

> . . . is an allowance for return on investment which is computed in a way that gives explicit considerations to the amount of capital employed (the rate base) as well as the cost of raising or retaining it (the rate of return). Operating expenses, or those deemed by the regulatory agency to have been appropriately incurred in the production of the service, are of course also included in computing the cost of service which is recoverable via charges on users of the service. (pp. 60-61)

Quirin (1986) comments on the "tendency of other regulatory systems to evolve toward this form." (p. 61) The inadequacies of less comprehensive systems lead the parties who are harmed by those inadequacies to press for improvements to the system. In Ontario, consideration of the landlord's return on equity had been ignored due to the difficulty of dealing with the matter.[24] The 1986 Act amends the Ontario cost pass-through system to give explicit recognition to return on equity in complexes brought under control for the first

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base-rate of return approach in several critical ways. See the description of the FMR system in Chapter 5.

23. The Inquiry's recommended regulatory system which establishes fair market rents is outlined in Chapter 5.

24. The discussion of financing costs in section 9.4 of Volume 1 of this Report observes that although allowing principal payments to be passed through as costs serves to provide landlords with a return on equity, it "is an unsatisfactory way of allowing landlords to make a return on their original investment."

time following the passing of that Act. In addition, special measure have been taken to correct the inequities resulting from ''chronically depressed'' rents. Those proposed changes demonstrate that the Ontario system is evolving, as have other regulatory systems, toward a rate base-rate of return scheme. However, it is still deficient in many ways relative to the rate base-rate of return regulatory schemes used in other industries.

The key elements of the rate base-rate of return system which require attention for the purposes of this Report are the methods by which the rate of return and the rate base are determined. The treatment of operating costs does not require attention because it is the same as that used in the cost pass-through approach. The difference between the rate base-rate of return and the cost pass-through approaches in that regard is that the total permitted operating costs for the year are included in the allowed rent in the former case, while the permitted increase in operating costs is used to set the rent increase in the latter case.

3.1.3.2.1 Determining the Required Rate of Return

Quirin (1986) presents a method[25] for estimating the rate of return private investors require to be be willing to finance rental housing developments. That method compares the risk and return of investing in rental housing to the risk in, and return from, alternative investments.[26] His method requires that the investments entering the analysis be in public companies with quoted share prices and dividend yields.

A number of corporations[27] operating in the residential rental market in Ontario produce audited financial reports and stock market data which permit a calculation to be made of the risk and the average return on equity or investment in that group. Most of those corporations are active as developers and investors in commercial as well as residential properties. It cannot be shown empirically that the data are representative of the residential rental

25. See chapter 3 and appendix 3-B of Quirin (1986) for details of an illustrative calculation of the required return of publicly-traded real estate companies as of April, 1985.

26. Conceptually, this approach determines the competitive rate of return for investment in rental housing by measuring the risk associated with investment in rental housing, comparing it with the risk of a sample of low-risk securities and of equity investments generally, then scaling the required return to reflect the relative risk. That approach implicitly assumes that the risk premium is constant per unit of undiversifiable risk, at least over the relevant range. See Appendix 3-B of Quirin (1986).

27. Quirin (1986) used eight to 10 property management and development companies listed on the Toronto Stock Exchange for a series of risk calculations for the period 1969 to 1985; Kalymon (1978) identified five for the period 1972-76; Muller (1978) identified five operating in Toronto for the period 1966-1975.

housing industry as a whole for purposes of determining the required return on equity. As a consequence, Quirin (1986) states:

> There is, however, the unresolved issue of whether or not the risk values determined for the publicly-traded real estate companies misstate their risk exposure in rental housing. (p. 168)

At the present time, however, no better data are available for estimating the risk and, hence, the required return on investment in rental housing.

Another concern with basing the estimates of the required return for landlords generally on the risk experienced by public real estate companies is that they are not typical landlords. The risk-return trade-off for those companies may differ from conditions in other segments of the industry. A significant portion of the industry consists of closely-held corporations. Data are not available to determine whether their returns differ from those of public real estate companies since the closely-held corporations are not publicly traded. Determining the market value of those corporations, which is required for Quirin's method, would be such an expensive and difficult task that for the purpose in hand it may be considered impossible.

On a still smaller scale are many thousand "small" landlords constituting close to half of the residential rental market.[28] Most of them employ relatively unsophisticated business and financial techniques. The statistical data required to determine in any scientific way the required return on equity, given the risk associated with the investment made by those landlords as a group, is simply not available at the present time and would be difficult to collect.[29]

Although Quirin (1986) acknowledges that his method of determining the required rate of return has a limited base, he states:

> In summary, it is our view that no compelling reasons exist for differentiating by size or type of landlord for rate of return purposes. (p. 168)

That conclusion must be taken in light of his earlier comment:

> The issue of whether or not the required rate of return for a given level of risk exposure varies among investors in rental housing cannot

28. Based on data in MMAH (1983, Table 5).

29. Campbell Sharp (1984, pp. 3 and 7) and Ekos (1985, pp. 22-28 and pp. 8-11 in Appendix B) discuss the difficulties of obtaining verifiable data given management and bookkeeping practices of many small landlords. There is also a response bias factor to questions in this area.

> be resolved on the basis of factual data. Nevertheless, the theoretical arguments against variation existing appear compelling. (p. 166)

A similar caveat applies to "the matter of relative risk exposure of various types of landlords." (p. 165) The inference from Quirin's comments is that the estimated risk of investment in the rental housing industry may differ from the risk of the total holdings of diversified real estate companies. However, the risk of the rental residential portion of the assets of diversified real estate companies should not differ from the risk of investment in rental housing by other types of landlords.

The Inquiry is not aware of any valid method of estimating the competitive rate of return with reasonable accuracy which does not engage in a calculation along the lines of Quirin (1986).[30] In theory, the estimate of the rental housing industry's required rate of return could be improved if data on returns earned by investors in rental housing other than public real estate companies were collected. It then could be used to determine whether the risk associated with their investments is greater or less than that of public real estate companies. However, the necessary data do not exist and cannot be made to exist due to the problem of circularity.[31] Still, if the required return for public real estate companies is used as the allowed rate of return for the industry, tests can be developed subsequently to determine whether the rate is adequate. Specifically, a shortage of investment by private real estate companies and individual landlords could indicate that the allowed return is less than their required return. A shortage of investment will be apparent by continued low vacancy rates and the desire by many landlords to convert or demolish existing units.

3.1.3.2.2 Valuing the Rate Base

As well as determining the appropriate return on equity to allow, it is necessary to determine the value of the equity base on which to allow a return. That base is the investor's interest in the property on which a return should be earned.

30. The details may be debated. For example, different financial investments may be used to estimate the risk-free rate, other samples of investments may be used to estimate the relationship between risk and return. Those issues do not alter the conceptual validity of the basic approach, however.

31. Circularity is a problem because the landlords' required return is calculated from their net income and the value of their property. The property value is the present value of future net income discounted at the required rate of return. Hence, the calculation is circular. Publicly-traded corporations do not suffer from this problem because their values can be determined from stock market data.

There are two distinct schools of thought on how the rate base should be valued. The first has what may be called a cost recovery orientation. It looks at the investment in rental housing as an investment which earns the current competitive rate of return, adjusted for the risk facing investment in rental housing. The allowed return would be earned on the historical value of the equity investment.[32] The return earned could in whole or in part be taken by the landlord as income or reinvested by paying down the mortgage thereby increasing the landlord's equity.[33] The permitted net income for any year would be determined by multiplying the equity base by the competitive rate of return. The equity base for subsequent years then would be determined by taking into account the landlord's reinvestment of his return and additional contributions of funds, less any withdrawals. The effect would be to ensure that the landlord earns the competitive rate of return each year and hence in total over the lifetime of the investment.[34] If this approach were applied to each landlord's residential rental property, the industry as a whole would earn no more and no less than the competitive rate of return. This approach reflects a common attitude toward public utilities where many people believe price should be adequate to recover all costs, but should not respond to other market forces (in particular, the supply of and demand for the factors of production, including land).

The second viewpoint could be called the market simulation approach. It considers the investment to have a speculative component in that conditions in the economy generally and the real estate market particularly may lead to capital gains or losses which should be included in the rate base on which a return is allowed. The substance of the second viewpoint is that landlords should earn the competitive rate of return on the current value of their property. Hence, if the value increases for any reason, the amount of the allowed return would increase correspondingly. Similarly, if the value of the property declines, so would the rate base and the income allowed. The landlord therefore might

32. From this viewpoint, the investment is similar to depositing money in a bank account.

33. The income also would be reinvested if it is used to cover a cash flow deficit that results from inadequate rental income (for example, in the first years of owning the building), extraordinary expenses or capital expenditures.

34. In practice, adjustments would be required to increase the equity base in years when the actual net income is less than the allowed net income. That would normally be the case during the first few years the building is owned, if cash flow returns or accounting returns are the returns measured by the regulator and the allowed return is the required nominal rate of return. The normal experience in the rental housing industry is that landlords earn real returns and compensation for inflation is realized through capital appreciation of their property. If the property is highly levered that may involve the landlord incurring a negative cash flow. In addition, mechanisms would be required to take into account the possibility that the property is likely to be sold eventually for a capital gain, but the size of the gain cannot be anticipated. See fn 22.

realize either capital gains or losses while the building is owned and the return earned over the lifetime of the investment would be uncertain. This approach most closely reflects the way competitive markets operate since price reflects market factors rather than historical costs.

Before deciding how to value the rate base for regulatory purposes, it is necessary to decide whether the purpose of regulation is to divorce price from market forces or to minimize the effects of imperfections in the market by attempting to determine the price which would result in a perfectly competitive market. An important determinant of that decision should be the practicability of choosing the cost-recovery approach given the present make-up of the rental housing industry.

The difference between the two approaches relates to changes in the rental value of a property when there are unanticipated changes in the attractiveness of its location.[35] In general, landlords believe that if there are unanticipated increases in the locational value of their properties, they are entitled to collect higher rents from the tenants who benefit from the favorable location. Many landlords believe they should be permitted to increase the rent even if sitting tenants are unable to pay it or do not consider the location worth the rent new tenants will pay. In the landlords' view, the allocation of units should be determined by tenants' ability and willingness to pay[36] the asking price for the unit. This is the basis used in our society for allocating most other goods and services produced by the private sector. On the other hand, many tenants would like rent increases to be no more than cost increases.[37] They feel they should benefit from unanticipated increases in the locational attractiveness of the property as a tenure right, without having to pay a higher rent. The essential

35. Anticipated increases in the attractiveness of the property's location would be capitalized into the value of the land at the time the land is purchased. Consequently, in order to earn a competitive return on investment, the landlord must realize the benefit of anticipated increases in rental value. It is normally assumed that actual increases in rental value are as likely to be over-anticipated as they are to be under-anticipated. If there are unanticipated increases, the industry would earn excess profits. See the discussion in section 4.3.

36. This statement reflects the market mechanism only in the short run when the total supply cannot be changed. For a period of time longer than a few months, the total supply of units to be allocated changes depending on the rent level. The higher the rent level, the greater the quantity of housing landlords will be willing and able to supply. The competitive market price serves to ensure the quantity of rental housing landlords are willing and able to offer at the prevailing rent level, will match the quantity of rental housing tenants are willing and able to rent. Low income households may be housed inadequately if the price they are willing and able to pay is less than the price at which investors are willing and able to make rental housing available. See the discussion of socially fair rent in sections 2.1 and 4.1

37. See Tables 5 and 6 and the discussion (pp. 45-47) in Knetsch, Kahneman and McNeill (1984).

issue differentiating the two approaches to determining the rate base is who should capture the gain from the increasing locational value — landlords or tenants.

There are several reasons for not accepting the cost-recovery approach to the valuation of the rate base. From the equity perspective, if the view is adopted that the tenant should enjoy the benefit of unanticipated increases in the locational value of the buildings in which their units are located, then tenants also should bear the cost of unanticipated decreases in locational value. But that symmetry is impossible to realize. If a unit's value increases so that it is worth more than the rent allowed under the cost-recovery approach and the tenant pays a rent which is less than the current market value of the unit, then conversely the tenant should be required to pay a rent which is more than the current market value of the unit when the allowed rent exceeds the market value of the unit. However, the tenant is free to leave and the landlord will have to reduce the rent or let the unit remain vacant. With a system which sets allowed rents but does not guarantee receipt of those rents, the landlord is always the one who will suffer the loss.[38] Since the landlord must suffer the consequences of value decreases, it is equitable they should benefit from value increases, if they should occur.

A further consideration with regard to the cost-recovery approach is that if the regulated rent is based on that valuation and is less than the market rent, tenants who are vacating their units can charge subtenants or assignees the market rents or key money and capitalize financially on the increased attractiveness of their units. If the subsequent tenant is going to pay someone for the increased locational value of the unit in any event, there is no persuasive reason why the previous tenant rather than the landlord should receive the financial benefit.

A further problem resulting from the cost-recovery approach is that because the owners of properties other than residential rental properties capture the benefits of increases in the locational values of their properties, a regulatory system which attempts to transfer those benefits from landlords to tenants will serve as a strong incentive for property owners not to provide rental housing. Condominiums and commercial buildings will be preferred investments.[39] Hence,

38. Economic theory argues that if a cost recovery approach were taken, investment would decline and the rent for new units would increase until investors were adequately compensated for this inequity. Hence, in the long run, rents for new units would be higher and tenants would be paying for the benefits they receive from the system. While that market process would remove the inequity, it would defeat the apparent intent of adopting the cost-recovery approach.

39. This statement assumes that the risk-adjusted rates of return for residential rental and other uses of the land are equal when capital gains related to anticipated increases in the land's locational value are treated equally for either type of investment. If those benefits are denied

a shortage of rental housing will develop over the years. To avoid that problem would require radical government intervention into the real estate market as a whole. There would have to be rigid legislation as to how land is to be used or else some way would have to be found of eliminating capital gains on all land. Either action could have a severe effect on the efficiency of the allocation of land within urban areas[40] and would necessitate treating the rental housing industry as a public utility.

Taking a public utility approach to rental real estate would require that a public authority acquire the land on which rental housing is located if the problems noted above are to be avoided.[41] The use of that publicly-owned land would have to be restricted to rental housing and investors would have to operate as public utilities, charging regulated rents. The characteristic of this approach would be that land would enter the rent calculation as an operating cost equal to the annual land charge levied by the government rather than as part of the capital base. Its current market value would not be relevant to the determination of fair market rent. There would be no opportunity to use the land in other ways in order to benefit from unanticipated increases in the locational value of the land since the government (probably a rental housing agency) would control the use of the land. Using this approach, the private segment of the industry would be limited to the ownership and management of the housing structures.

Payment to the present owners of land could be made by interest bearing debt obligations which would be retired from fees paid by landlords for the use of the land. Conversion to a public utility in this manner appears to the Inquiry to be the only way to deprive landlords of inflationary and locational increases in the value of the lands occupied by them.[42]

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to owners of land who invest in residential rental property, they will anticipate lower returns until the market adjusts to the differential treatment of land. Residential rental housing supply will decline and the supply of land for alternative uses will increase, relative to demand, until the risk-adjusted returns are equal. After some period of time, higher rents will compensate landlords for the loss of the right to capture the benefits of increased locational value.

40. See Muller (1986, pp. 110-118) and Stanbury (1985, #15, Ch. 5).

41. If the land is not publicly-owned and its use not restricted to rental housing, landowners would have an incentive to use the land for other purposes if they anticipated that the value of their land would increase. In future years they would be able to earn the competitive rate of return on the increased land value if it were used for some purpose other than a residential rental building. Used as a site for a rental building, regulated in accordance with the cost recovery approach, the land value would be frozen at its historic cost and a return would be earned only on that lower value. Landowners therefore would use their land in other ways unless the return allowed for residential rental properties provided a premium over alternate uses which compensated for the lost opportunity and eliminated the benefit to tenants of the cost recovery approach.

42. It should be noted that over time, the rents for properties with their rents set on a cost

Quirin (1986) enumerates the following alternative methods for valuing the rate base on which a return is permitted.

(1) Original (Historical) Cost
    (i) to present owner
    (ii) to initial owner, less depreciation
(2) Adjusted (Trended) Original Cost
    (i) to present owner,
    (ii) to initial owner less depreciation
(3) Replacement/Reproduction Cost
    (i) less book depreciation
    (ii) less observed depreciation
(4) Market Value
(5) Fair Value
(6) Undepreciated versions of (3), (4) and (5)
(7) Par Value of outstanding securities
(8) Book Values of outstanding securities (p. 69)

In terms of the two approaches discussed above, methods (1), (2), (7) and (8) are cost-recovery approaches. Methods (3) and (4) are market-simulation approaches. Method (5), fair value, is a compromise between the two.

If the real cost of housing were constant[43] in a perfectly competitive market, the two approaches would produce the same result. Quirin's (1986) chapter examining alternative methods of determining the rate base implicity assumes that is the case. He therefore concludes:

> Our review suggests that the choice from among the available rate base valuation methods should be based on regulatory expediency and industry characteristics. All are *capable* of providing adequate inflation protection to the equity investor, a necessary feature to attract capital and one which is conspicuously lacking under present

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recovery basis would fall below the competitive market level if land values increase. As a consequence, excess demand would arise and ways to allocate the units would have to be developed. Whoever controlled access (sitting tenants, the property manager, etc.) would be in a position to assign units in return for key money, or on the basis of some form of favoritism. One solution would be to rent those units to low-income households. Rents could be geared to income and if actual revenue fell below market level, a subsidy could be paid by government. In effect, that is how non-profit housing is currently handled, although additional subsidies are built into the initial financing of the project. It is doubtful that this approach realistically could be applied throughout the rental market.

43. The real cost of housing is constant if the market clearing price in nominal terms changes at the same rate as the general inflation rate. In that case, trended original cost equals replacement cost.

> [Ontario] regulatory arrangements. None, however, provide the potential for windfall gains during inflation that characterized the unregulated market. (p. 245)

No consideration is given by Quirin to the conceptual differences which become important when there are unanticipated changes in the locational value of property, an occurrence which is inevitable over the lengthy time periods characteristic of investment in rental housing. Those changes in value must be taken into account in considering his review of the alternative rate base valuation techniques.

Each approach presents serious implementation problems. After eliminating other approaches because of a variety of problems, Quirin (1986) concludes:

> These problems can be overcome, to a significant extent, by use of a trended historical cost standard, in which acquisition costs, and costs of capital improvements, are brought up-to-date by using a price index. (pp. 247-8)

With regard to a suitable price index, he argues:

> . . . an index of general purchasing power is more appropriate than an index of replacement cost. The appropriate index, given these purposes, is the Consumer Price Index (CPI). (pp. 248-9)

To avoid repeated valuations of properties, Quirin (1986) suggests owners of pre-1986[44] properties be required to register the 1985 value of their property either at the time of, or prior to, their first review hearing. Properties first rented in 1986 or later would be registered at their initial capital values. In either case, the "registered values should be divided into land value and building value components." (p. 263) Only the building value would be depreciable.

On the issue of the rate of return, Quirin (1986) concludes:

> The appropriate rate of return to use with a trended cost rate base is a "real" rate, purged of its expected inflation component. (p. 249)[45]

44. This and the following references to a particular year are explained simply by the fact that the study was written and published in 1986. They carry no other implications.

45. The real rate would be derived from the nominal required rate of return estimated by the technique discussed above, using the rate of inflation for the same time period as the data for estimating the industry risk and return.

However, because of practical difficulties related to the fact that debt is payable in nominal dollars, Quirin (1986) argues that the review system should:

> . . . allow embedded nominal cost on those portions of the rate base financed with debt, and a real equity return on the balance. We have given serious consideration to using an original cost-nominal return framework, but have concluded that this course would create even more mischief than the course we have chosen. (pp. 249-50)

After extensively reviewing the experience with the rate base-rate of return method of regulation, Quirin (1986) makes the following germane concluding remarks:

> The length of our review of the rate-base-rate of return method of regulation gives some idea of its complexity. It is this very complexity that gives this method of regulation, more than any other, the flexibility to operate in a diversity of industries not only in companies conforming to the norm of their industries but in companies deviating from that norm, and to do so successfully, if success is defined as operating at prices which are the lowest consistent with the need to attract capital. While other regulatory models are simpler, the simplicity is usually gained at the cost of one or another party to the regulatory process.
>
> The complexity of the rate-base-rate of return model also makes it an extremely expensive form of regulation. A contested rate case involving a company regulated under this model may absorb anywhere from 2 to 100 hearing days, perhaps in the order of four or five man-years of effort involved in preparing the case, hearing it and adjudicating a decision. Most of the cost is for manpower, but there will also be travelling expenses and computer time as major items. The real challenge is to find a version which can do what the rate-base-rate of return system can do, but do it at a thousandth, or less, of the cost. (p. 139)

In recognition of the problem of complexity, Quirin (1986) suggests several procedural modifications:

> 1. encourage joint hearings (for example, a single the hearing could deal with all the buildings owned by the same landlord within a municipality or several landlords could form a rating group) (pp. 254-6),

2. do not deal with the cost of capital on a case-by-case basis but use a single, industry wide cost of capital figure (pp. 256-8),

3. use automatic escalators rather than actual costs for certain standard expenses (pp. 259-61),

4. exempt all buildings with four units or less and units over shops in two-storey structures (p. 256),

5. in lieu of a rate base-rate of return review allow rents to increase annually "at a rate at least 1 per cent, and preferably 2 per cent in excess of the realized rate of inflation in the prior year" (p. 286).

The reason for those procedural modification is, in Quirin's (1986) words:

> The ability to regulate is contingent on there being a high rate of "opting out"; in effect this involves using rents of major landlords regulated on a cost-of-service basis, as a control device; should exempt or opting out landlords seek to charge more, vacancy rates can be relied upon to provide a measure of discipline. (p. 262)

Under a rate base-rate of return system, the rents chargeable for the year would be the amount required to pay costs for the year and provide a return on equity for the landlord. The process is illustrated by an example given by Quirin (1986, pp. 267-268) which breaks down the calculated allowed rent into four components: 1. the operating cost component; 2. the debt service component (includes interest and depreciation); 3. the equity return component; and 4. the income tax component.

With regard to the issue of whether the landlord or the tenant captures the benefits derived from unanticipated increases in the locational value of the property, it is apparent that with Quirin's (1986) approach the benefits are split. During the lifetime of the building the rents will not reflect increases in the property's locational value; hence, the tenants will capture the benefits.[46] However, when the building is demolished, renovated or converted, the landlord will realize a capital gain reflecting the increased locational value of the property. Either the building would be sold at its market value, reflecting the locational premium, or if the property were developed by the original owner, it would command higher rents in its new use. With the benefits split in that

46. The procedural modifications which simplify Quirin's (1986) system and the use of nominal instead of real debt costs in calculating the allowed return would tend to create opportunities for landlords to capture some of the benefits of increased locational value. Hence, even during the lifetime of the building, the benefits would be split in practice.

fashion, the landlord would have an obvious incentive to demolish, renovate or convert the building much sooner than if the benefits of increases in the locational value of the property could be captured during the lifetime of the unaltered building.[47]

Quirin's (1986) study is the only comprehensive analysis of methods for setting the allowed rent rather than the allowed rent increase which has been brought to the attention of the Inquiry. Although the rate base-rate of return approach is clearly more equitable in concept than the simpler cost pass-through approach, the Inquiry has several reservations regarding the rate base-rate of return method set out by Quirin (1986). His approach would be quite appropriate for an industry consisting of a single firm or an industry consisting of a few large firms with similar costs. However, in the context of the rental housing industry which is extraordinarily heterogeneous, a few adaptations of the method are necessary.[48]

First, on the issue of the method of determining the rate base, Quirin (1986) prefers the trended original cost to the untrended original cost approach for a number of convincing reasons. However, those reasons are only relevant for the determination of the value of properties at the time the system is introduced, that is in 1986 to use Quirin's assumption. It would be both equitable and practical to determine 1986 property values using the trended original cost approach and then use either those 1986 base values, untrended with the nominal required rate of return, or the trended 1986 base values, with the real required rate of return to update the rate base annually. Although Quirin (1986) suggests using the latter approach, he modifies it by suggesting that the nominal rate of return be allowed on debt financing to avoid cash flow problems. That would enable the landlord to earn more than is justified by the cost-recovery principle. If the cost-recovery principle were accepted, it would follow that 1986 base values for all properties should be determined using the

47. The gain realizable through demolition, renovation or conversion will be capitalized into the property value before anything is done. Hence, its value will increase in anticipation of the end of its economic life. If permission to demolish, renovate or convert is difficult to obtain, the anomalous situation may arise in which run-down buildings which need to be demolished are worth more than buildings that are in good condition and suitable for continued occupation as rental housing.

48. Muller (1986) states:

> Imposed without modification, Quirin's scheme would have two severe defects. First, the high initial rents could not be achieved until market rents had risen far above the rent which would induce entry into an uncontrolled market. Secondly, the scheme does not achieve its goal of restraining the landlords' return to a "fair" level . . . the internal rate of return on the investment project is over 19%, or 9 points higher than the "fair" return of 6% plus 4% inflation. (p. 207)

Those defects are recognized in the discussion which follows.

trended original cost approach, and the nominal required return should then be allowed on those base values. The rate base would not be trended after 1986.

The market value approach to setting the value of the rate base is rejected by Quirin (1986) due to the problem of appraising the value of rental properties. However, if the market simulation principle were accepted as the basis for regulation, a method that at least attempts to determine market value would be needed. One possible approach would be for the regulatory body to develop a data base of land values which would enable it to estimate the current land value of any rented property.[49] The trended original cost of the building (adjusted for depreciation and capital expenditures) could be added to the market value of the land to provide an estimated market value for the property (land plus building) which would avoid both the appraisal and the circularity problems.

A further reservation with regard to Quirin's (1986) approach relates to the fact that he suggests allowing all landlords the same return on equity regardless of the leverage of their investments. In fact, the required return on equity investment depends on the amount of leverage since leverage is an important determinant of equity risk.[50] It would be impracticable to deal with this problem by developing a sliding scale of allowed returns based on the financial leverage. It would be practicable, however, to determine the allowed rate of return on capital rather than separate allowed rates of return on debt and equity. That would reflect the average (or optimal) leverage of the industry and would eliminate the problem of the allowed rents being affected by the way the landlord finances the property.[51]

49. Note that it is not adequate to simply value the land separately from the building. Rather, the estimate of the land value must be used as a proxy for the actual land value since that value is dependent on the rents allowed by the regulatory system when there are restrictions on converting the land to alternate uses. The proxy should be an index of land values based on a land value data base would have to include land transactions involving properties other than residential rental properties. The values of residential rental properties are not independent of rent regulation. Further study will be necessary to determine the best way to value land, taking into account location, zoning and other factors, to avoid creating a disincentive to committing land to residential use.

50. Financial leverage is determined by the relative proportions of debt and equity. The equity of an investor owning a building which is financed 85 per cent by debt is at much greater risk than the equity of an investor owning a similar building which is only 50 per cent financed by debt.

51. There are precedents for this practice which demonstrate its feasibility. For example, the U.S. Federal Commerce Commission uses what it considers to be the optional (cheapest) capital structure in setting telephone rates for AT&T. The company receives no compensation for high capital costs which result from deviations from that capital structure.

A related concern is that with the Quirin approach the allowed rent would be affected by a landlord's actual mortgage costs. As in the case of leverage noted above, the concern could be resolved by allowing a return on capital which reflects the average cost of debt and equity for landlords generally rather than their individual debt costs.[52] Landlords with unusually high financing costs would face a cash flow squeeze. However, such situations would develop as a result of the interest rate risk levered investors face in any business activity and there is no reason why the regulatory system should be designed to protect investors from those normal business risks.

Another concern with Quirin's (1986) approach is that it necessitates taking several measures to avoid the excessive administrative burden which would result if a full rate base-rate of return hearing were required for every Ontario landlord.

Each of those modifications compromises the theoretical validity of the rate base-rate of return approach.[53] By the time the regulatory mechanism is made manageable, the rate base-rate of return would be used to determine only a small minority of all rents. Furthermore, the system would be likely to set rents which differ significantly from the rents which were conceptually intended. It is far from clear that the rate base-rate of return approach would set rents which are more equitable than rents set under simpler systems which take into account the landlords' equity by means of ad hoc adjustments to the allowed rent increase.[54] A workable regulatory system which is based on the rate base-rate of return principle but requires fewer compromises would be preferable. An approach which accomplishes that is presented in Chapter 5.

As was indicated at the beginning of this section, the most serious reservation to implementing a rate base-rate of return system of rent regulation relates to its conceptual basis, not its practical difficulties. The appropriate way to use this approach in the rental housing industry is on a long-term industry-wide basis, not on a short-term building-by-building basis. Although

52. Using a standardized allowed return on capital is consistent with the principle of determining allowed rents on the basis of industry-wide costs rather than individual building costs. That issue is examined more fully in Chapter 2 and later in this section.

53. In his testimony, Quirin acknowledged the extreme practical difficulties with using the rate base-rate of return approach on a building-by-building basis. In his study for the Inquiry, Quirin adapted the rate base-rate of return approach as best he could to the circumstances of the rental housing industry. Whether the resulting scheme is better than no regulation, or the FMR system described in Chapter 5, was not addressed in the study.

54. For example, the systems used in Quebec and Massachusetts may be simpler and just as effective at building a reasonable return on equity into allowed rents.

the distinction is not important in some regulated industries, it is important in the rental housing industry.

It may be appropriate to set rents by means of an individual building rate base-rate of return determination in regulated industries where there is a monopoly or a small number of virtually identical firms. In that type of industry, determining prices on the basis of the returns of individual firms is not significantly different from determining them on the basis of the industry's return. However, in rental housing, which is a diverse industry with many suppliers, the rate base-rate of return approach will not establish fair market rents for the reasons discussed in Chapter 2. The individual building approach would create inequities among tenants because allowed rents for similar units would vary considerably. Furthermore as explained in section 2.2.2, although the rate of return on investment of individual landlords would never exceed the competitive rate of return, landlords with relatively high costs would be unable to collect the rents the system allowed them to charge unless vacancy rates stayed low. If no landlord is allowed to earn more than the competitive rate of return, but some earn less, the expected rate of return for investors would be less than the competitive rate. Investment would be discouraged.

It has also been shown in section 2.2.1 that it is not appropriate to set rents by means of a rate base-rate of return determination which utilizes the short-run, rather than the long-run (life of the investment) rate of return. In a regulated industry where companies are large and have asset bases which are mixed in terms of the ages of their assets, the accounting rate of return will be fairly constant through the years. As a consequence, the differences between prices determined by applying the required rate of return on a long-run and short-run basis are not likely to differ significantly. However, in the rental housing industry, where many landlords own only one building, the accounting rate of return will increase with the age of the building. Setting rents so that the allowed return is the required rate of return throughout the life of the building will not work.

For the foregoing reasons, the Inquiry does not consider the rate base-rate of return approach, if used on a case-by-case basis, to be a suitable rent review technique. Neither it nor any other regulatory mechanism which attempts to determine fair market rents on a building-by-building basis can succeed in the task of determining fair market rents. However, the rate base-rate of return approach has been adapted to serve as the basis for determining the guideline rate for a rent control system within the Fair Market Rent system outlined in Chapter 5. Using the rate base-rate of return approach to determine industry-wide fair market rents is conceptually consistent with fair market rent as defined in Chapter 2 and enables the regulatory process to be made workable without compromising the intent or the integrity of the system.

3.1.3.3 Market Comparison

The market comparison approach to rent review is concerned only with ensuring that rents for units being reviewed are not unreasonable when compared with the rents being charged for similar units by other landlords. Rents which are either high or low relative to the normal charge for similar units would be adjusted to remove the discrepancies. That approach can be used to reduce variations in rents for similar units but it cannot be used to change the general rent level in the housing market. Whether the market comparison approach would set rents which are fair market rents would depend on the competitiveness of the rental market.

In theory the rents charged in a competitive rental housing market will be fair market rents. That is the case because competitive forces will drive rents down to the point that they are just sufficient to cover operating and capital costs, including the required return on equity investment.[55] Consequently, under competitive conditions, market rents will be fair in the sense that landlords will not earn excess profits. Under those conditions, a market comparison review mechanism would be sufficient to ensure that individual rents, as well as the general rent level, are fair. However, if the rental housing market is not competitive and the average rent level is above or below the fair market rent level, then a market comparison review system would not establish fair market rents.

Appendix D examines the evidence pertaining to the competitiveness of the rental housing market. The standard indicators of competiveness support the view that the industry is highly competitive relative to the norm in other Canadian industries. It follows that under normal conditions rents will deviate from the fair market level only in exceptional cases.[56] Hence, an adequate regulatory system under normal conditions in Ontario would be one which identifies rents above or below the general market level and adjusts them accordingly. That could be accomplished by a market comparison system of rent review.

Conditions in the current state of the Ontario residential rental market cannot be considered to be normal conditions, however. Appendix F shows that the past decade of rent regulation has depressed rents below the fair market level and has discouraged new investment to the point where rental housing is undersupplied. A system of rent regulation which places no constraints on the general market level of rents could result in rents above the fair market level in the short-run. Consequently, while a market comparison system of

55. The mechanism by which competition operates is described more fully in Chapter 2.

56. For example, cases of excessive rent charges are discussed in section 4.2, and where market rents have led temporarily to a high rent level, as discussed in section 4.4.

rent review may be adequate in itself as a regulatory system under normal market conditions in Ontario, it would not be appropriate under current conditions.

However, if the rental housing market could be brought back into balance with vacancy rates in the two to five per cent range, competition could be expected to control rents so that they would be at the fair market level. In that case, rents generally would not have to be regulated and a market comparison system of rent review would work satisfactorily in protecting tenants against excessive rent charges.

3.1.4 Rent Control

A rent control system of rent regulation is defined in this Report as a system which sets a fixed limit on rent increases for all rental units or for specified portions of the total market. The fixed limit is referred to as the guideline. It may be set by statute or regulation, by formula, or by an administrative or quasi-judicial hearing process.

The primary advantage of rent control is that it offers administrative simplicity and minimal transaction costs for both landlords and tenants. The financial information of individual landlords need not be prepared or reviewed since the permitted increase is determined by the guideline which applies to all tenancies.

The simplest form of control system sets the guideline rate without providing an administrative mechanism for changing it as market conditions change.[57] In general, only rent control schemes intended, initially at least, to be temporary in duration have taken this form.[58] The Ontario scheme utilized a statutory guideline from its inception in 1975 until the end of 1986. It was reduced by the legislature on two occasions. The problem with a statutory guideline is that it tends not to be responsive to market conditions and changes are subject to the vagaries of the legislative process. Hence, even if the guideline was fair in its impact on landlords and tenants when it was initially set, it is unlikely to remain so as conditions in the economy and in the rental housing market change.[59] This disadvantage of a statutory guideline can be reduced, as has

57. The most extreme type of control is a rent-freeze, which allows no rent increases and historically has been a short-term emergency measure. Quirin (1986, pp. 24-30) discusses rent freezes.

58. Adams, Ing, Ortved and Park (1986) survey rent control systems in numerous jurisdictions. Ontario is an example of a jurisdiction which had no provision for changing the guideline. Although changes were made on an ad hoc basis as political and economic conditions changed, the 1986 Act has introduced a rate which is determined on an annual basis and is linked to various cost indexes.

59. See the table and discussion in section 1.3 of the relationship between the guideline rate and the inflation rate in Ontario.

now been done in Ontario, by substituting a formula for adjusting the guideline to reflect changing conditions at fixed or discretionary intervals.

Rent control systems have been criticized because the financial situations of landlords differ so widely that a rate which deals fairly with some inevitably will be inadequate for others and too generous for still others. That argument is premised on the assumption that equity among landlords requires that they be equally profitable.[60] That assumption has been rejected in this Report. In a competitive rental housing market, landlords receive similar rents for similar units and the market level of rents reflects the expected costs of the average landlord.[61] Those with above average costs will suffer below average returns on their investment; those with below average costs will realize above average returns. Equity does not require a regulatory system which considers the circumstances of individual landlords. What is important is: 1. that the guideline rate reflects the rate of change in the fair market rent level, and 2. that the base rents to which the guideline is applied are fair market rents.

The rate of change in the level of fair market rents can be estimated by means of a rate base-rate of return hearing for the industry as a whole or more practically for a representative sample of landlords. A regulatory system along those lines is examined in Chapter 5. However, because no guideline rate can take into account the fact that the gap between the base rents and fair market rents may differ for different units, a guideline mechanism alone would be incomplete. The FMR system outlined in Chapter 5 takes into account both the differences between base rents and fair market rents and changes in the fair market rent level.

To reduce the administrative burden and complexity of determining the guideline rate in that manner, a rough indicator such as the CPI[62] can be used.

60. At no time during the Inquiry's deliberations was a case put forward to argue that rent regulation should be used to reduce the differences among the returns which would be earned in an unregulated market. On the contrary, those differences are important for providing an incentive to landlords to keep their costs down. For that reason and others, it was argued in Chapter 2 that the appropriate criterion for fair market rent should be the long-run industry return, not the return of individual landlords. Ensuring that all landlords earn the competitive return is not put forward as an objective of rent regulation in Chapter 4.

61. This statement assumes all landlords face similar expected costs for mortgage financing, heat, taxes, etc. over the lifetime of their investments. Actual costs may vary substantially, however. For a more detailed discussion of the relationship between landlord costs and the competitive rent level see Muller (1986, pp. 110-118) and Stanbury and Vertinsky (1986, pp. 7-23 to 7-28).

62. An endless variety of methods for simplifying the determination of the guideline rate are possible. Inevitably, there is a trade-off between conceptual validity and simplicity. In Manitoba and Saskatchewan the guideline rent increases include an economic adjustment factor which is set annually by the administration.

The problem with this approach is that it would introduce the opportunity for a large measure of discretion in setting the rent; i.e. What indicator to use? What adjustments should be made to it? That being so the guideline rate setting process would become highly susceptible to political pressure. The result could be a high rate offering little protection to tenants or a low rate discouraging investment and leading to rental housing shortages. The outcome would depend on whether landlords or tenants wielded more political power not on what guideline rate would allow rents which are fair market rents. For that reason an approach which explicitly determines the level of actual rents relative to the fair market rent level is preferred.

3.2 Budgetary Policies

The common feature of the policies and programs discussed in this section is that they involve the use of government funds either directly or indirectly in the form of tax expenditures.

Budgetary programs embrace a wide range of activities conducted by governments at all levels, frequently acting in collaboration. Some are designed to induce investors and landlords to build and renovate residential housing. Others provide households with funds to assist them in buying or renting such housing. Still others finance, and sometimes develop and manage, housing in forms which would not otherwise become available, particularly socially assisted housing. Although the Inquiry is concerned only with rental housing, ownership programs cannot be ignored since many have important effects on the rental side of the housing market.[63] The comments which follow address ownership policies only to the extent that they have an impact on the rental housing market.

Rental housing programs which have functioned in Ontario over the past 50 years have been numerous and varied and devised by both the federal and provincial governments.[64]

Two major purposes of the various budgetary programs introduced since 1919 have been to stimulate the economy generally in periods of high un-

63. For examples, the Assisted Home Ownership Program (AHOP), the Canadian Home Ownership Stimulation Program (CHOSP), the Home Owner Grants program and the Registered Home Ownership Savings Plan (RHOSP) at the federal level, and the Renter-Buy Program, Ontario Home Buyers Grant Program and Home Ownership Made Easy (HOME) program at the provincial level, assisted tenants and lower and moderate income families to purchase homes. All of these programs have ended. These and others are described in Adams, Ing, Ortved and Park (1986, Section 2).

64. Chapter 1 in Chant (1986) sets out in chronological order digests of 36 housing programs which have operated or are operating in Ontario.

employment and to increase the supply of housing.[65] Although much of the funding provided was directed to lower cost housing, many of the programs stimulated the supply of housing which was beyond the means of low income households. Rental programs, in contrast to ownership programs, were more frequently aimed at assisting lower income households. Most were financed through cooperative federal-provincial efforts. However, around 1978, both the federal and provincial governments began to withdraw from these programs as "the staggering costs and massive inequity of the program toward individuals became evident." (Task Force on CMHC, 1979, p. 10)

The Task Force Report on CMHC (1979) concludes its historical review with the following comment:

> It is clear from this brief historical description that the emphasis of CMHC and provincial agency activity has evolved continuously over the past 40 years. Throughout this period, housing has been used, when thought necessary, as an economic stimulation tool. However, the thrust of federal and provincial policies has shifted considerably beginning with the emphasis in the thirties and forties on employment and demand stimulation, shifting in the fifties to a concern with the availability of housing finance, and in the late sixties and most of the seventies to a preoccupation with social policy and income redistribution. Finally in the late seventies we have witnessed a reduction in government assistance and direct market intervention. (p. 11)

The Ontario government continues to consider the economic benefits of budgetary housing programs to be important. In the Minister of Housing's remarks to the legislature on December 16, 1985, introducing the program of Assured Housing for Ontario, he said it was based on five main elements, the fourth of which was ". . . a commitment to a dynamic, efficient private build-

65. Task Force on CMHC (1979), *A Report on Canada Mortgage and Housing Corporation*, states:

> The federal government first entered into housing policy in 1919 . . . The rationale behind the program was not to provide housing for any particular group but rather to relieve what was thought to be a general scarcity of housing for Canadians.
>
> During the 1920s . . . the major objective of this policy was to stimulate the economy.
>
> The year 1938 saw the introduction of the National Housing Act with the following objectives stated by the federal Minister of Finance.
>
> i) A substantial contribution to the elimination of unemployment in the field where it had been most heavily concentrated, and to the general stimulation of business recovery; and
> ii) A substantial contribution to the improvement of housing conditions particularly for families with low incomes.

ing industry which will continue to be a major source of employment in Ontario.''[66]

The issue of economic stimulation is beyond the scope of this Report. To deal with that issue would require: 1. explicit consideration of economic conditions; 2. development of programs to optimize the timing of rental housing construction; and 3. determination of how to finance government expenditures so as to minimize offsetting dampening of the economy. The appropriate answers would change with economic conditions. Suffice it to say that the programs required to realize the objectives discussed in Chapter 4 should be timed and financed so as to maximize the benefits to the economy.

The remainder of this Chapter is divided into two sections: market augmenting programs and market replacing programs. Market augmenting programs are further divided into demand programs, supply programs and combined programs. Each type of program is defined and major advantages and disadvantages identified.

3.2.1 Market Augmenting Programs

Under the heading ''The Workings of Market Augmenting Policies'' Chant (1986)[67] says:

> Market augmenting policies can be identified by the fact that they work through altering the behaviour of private participants in the rental market by increasing their willingness to demand or supply rental housing in face of any given set of incentives or signals emanating from that market. . . . (p. 92)
>
> Market augmenting policies differ according to whether their proximate effect influences the demand or the supply side of the rental market. Market augmenting policies on the demand side work through influencing the demands of households for housing, whereas, supply policies work by influencing property owners or developers to increase the supply of rental housing. A wide variety of specific policies and programs are covered under these classifications. (p. 95)

The following sections examine the different types of market augmenting programs.

66. Hansard, official Report of Debates, Legislative Assembly, Dec. 16, 1985. p. 2455.

67. Chant (1986) provides an extensive assessment of each type of program within the framework of policy objectives relevant to the Inquiry. This section of the Report provides a relatively brief overview to assist the reader to understand the conclusions and recommendations set out in Chapter 6.

3.2.1.1 Demand Programs

Generally speaking, programs coming under this head take the form of payments made directly to tenants. The most commonly discussed form of demand program is a shelter allowance.[68] The province of Ontario does not have and never has had a shelter allowance program. The pros and cons of such programs have been studied intensively from both conceptual and practical points of view but it cannot be said that there is anything approaching a consensus regarding their merits or disadvantages.

Shelter allowance programs are designed to benefit only households which meet specified criteria, usually related to household income and either actual housing costs or an amount which should be sufficient to afford adequate housing. Those households are subsidized because their housing needs cannot be supplied by the private market at a price they can reasonably afford. A number of reasons have been put forward for subsidizing tenant households by paying them shelter allowances. Among the reasons are the following:

1. The basic problem facing households which would qualify for a shelter allowance is inadequate income and the assistance responds directly to that problem. Whether it would be better if the problem of inadequate income were dealt with comprehensively rather than piecemeal is another question.[69]

2. A probably large but undetermined proportion of tenant households which would qualify are occupying premises of their own choice which are acceptable to them but which take an excessively large part of their incomes. Shelter allowances would provide immediate relief by increasing the amount of income left over for other living costs and make it unnecessary to move to subsidized housing in order to reduce rent costs.

3. For those households living in squalid or highly unsatisfactory conditions because of inadequate income, shelter allowances provide the means to improve the household's position quickly if adequate housing is available.

4. Preserving the household's freedom to choose where it wants to live is an important consideration and a valuable attribute of shelter allowance programs. Putting money in the hands of needy households will give their members

68. Shelter allowances are often referred to by other names. A housing allowance is the same thing and generally refers to a program available to both owners and renters who meet the program criteria. Rental allowances are similar programs with benefits available only to renters. Further distinctions can be drawn between different types of shelter allowance programs. For example, they can be constrained or unconstrained. See Chant (1986, Chapter 4) and Steele and Miron (1984, pp. 72-74) for more detailed discussions.

69. See the discussion of the affordability problem in section 4.1

a feeling of being part of the community much more than if they are assigned by an administrative procedure to a certain type of housing in a certain locality.

5. Shelter allowances will increase the number of households which can afford fair market rents for suitable accommodation. Under normal market conditions, availability problems would be eased since private investment in rental housing would be stimulated and supply increased. That assumes the level of assistance is high enough to enable households to afford the economic rent for rental units which are supplied by the private market.

6. Shelter allowances treat all qualifying households equitably. Under existing programs of socially assisted housing, those households fortunate enough to gain admission enjoy all the benefits while others, including qualified households on the waiting list, get nothing.

As mentioned above, shelter allowances do not have unanimous support. The criticisms take several different forms. From the point of view of some of the tenant advocates who appeared before the Inquiry it is said there would be a social ''welfare'' stigma whereby the recipient would be treated as a second class citizen. This remark would seem to be of doubtful validity. Government support systems are so ubiquitous these days it is hard to see why a shelter allowance would be any more demeaning than being in subsidized housing.

A further criticism of shelter allowances is that they do not ensure more housing will be built. The inference is that there is insufficient housing for low-income households. The problem of availability, however, is distinct from the problem of affordability. Whether or not a housing allowance program will resolve availability problems as well as affordability problems is not a reason for denying households the assistance a shelter allowance could provide. Separate policies to respond to availability problems can be implemented if necessary; however, it should be noted that market theory suggests that if households have the means to pay a fair market rent, over the long term there will be no availability problem.[70]

That there is a problem of there not being sufficient housing affordable by low-income households and that the situation may become more acute is widely recognized. However, the actual dimension of the problem as it now exists is not known, although waiting lists for public housing are some indication.[71] There are many reasons why a household would apply for admission to socially assisted housing. OHC does not break down the lists it maintains

70. See the discussion in section 4.8.

71. See Chant (1987, pp. 326-328) and his testimony Transcript Vol. 112-2, pp. 48-50 and Exhibits 72 and 73. See also section 4.8.2 of this Report.

to show how many applicants are without accommodation because there is nothing available they can afford. To the extent that households are adequately housed but are paying more than they can afford, a shelter allowance program could quickly resolve their difficulties. While publicly-funded new construction also would be helpful to those households, it would take a lengthy period of time before an adequate supply of socially assisted housing could be made available. Even if there is an absolute shortage of adequate housing, a policy of shelter allowances would induce private landlords to make additional housing available in a much shorter period of time.

A somewhat similar criticism is that shelter allowances will do nothing to improve the condition of the housing in which some low-income households live. Again this assumes only public financing can improve their condition. It is not unreasonable to say, however, that the additional income provided by shelter allowances would induce both landlords and tenants to improve the quality of existing accommodation. With the means to afford better accommodation, many households would move if landlords did not improve the premises. Furthermore, if tenants had the means to afford higher rent, housing standards could be more strictly enforced without running the risk that rents would be increased to a level which would be unaffordable by the occupants.

A frequently heard criticism of shelter allowances is that the increased household income would be absorbed by increased rents and only landlords would profit. In cases where the rent being paid by the tenant is below a fair market rent but the rent received by the landlord is raised to the fair market rent level via a housing allowance, the effect is to transfer the cost of the household subsidies from the landlord to the government. This is no different than the effect of other social programs which transfer the responsibility for assisting those in need to the public. If landlords were able to charge in excess of a fair market rent for units occupied by households receiving assistance, it would be necessary to regulate the rents to ensure they are not excessive.[72] With a mechanism to regulate rents in place, however, this criticism of shelter allowances is not valid.

Criticism of shelter allowances from the practical and administrative viewpoint is concerned with such matters as a low take-up rate, high cost and excessive bureaucratic administrative features. It is somewhat of an anomaly that households regarded as having an affordability problem do not take advantage of income supplements when made available. This could be so because potential recipients are unaware of the subsidies available to them, prefer to pay their own way, or perhaps are unwilling to disclose the personal or financial

72. The discussion of excessive rent charges in section 4.2 examines the extent to which it is possible for landlords to charge excessive rents in the rental housing market. While there are circumstances in which excessive charges can occur, they are the exception, not the rule.

information demanded. A well managed and designed shelter allowance program could minimize the bureaucratic "red tape" which might deter potential recipients from applying and add to administrative costs. An efficient program also would ensure that information on shelter allowances was well disseminated.

A final criticism made of shelter allowances is one that is applicable to any social program intended to relieve the burdens of some class of society. It is that it involves more bureaucratic superstructure and intrusion into the privacy of those whom it is intended to benefit. There would seem to be no way of avoiding those developments as the state becomes increasingly involved in social programs.

3.2.1.2 Supply Programs

Programs under this heading operate at every stage of the market to influence the decisions of suppliers, from developers through to builders and landlords. By way of examples and not as a complete recital of supply policies, they can take the following forms: builders can be provided with loans and subsidies, and mortgage money can be made available at reduced rates; sales tax concessions on construction materials can be given to reduce costs; and accelerated depreciation can increase the profits. The Multiple Unit Residential Building (MURB) program afforded developers and landlords substantial income tax relief and was a popular policy for a number of years.

Statistics are available regarding expenditures, including tax expenditures under most supply programs and estimates of the quantity of housing which has resulted. A direct comparison of the effectiveness of the various supply programs in relation to cost or other criteria is not available, however.[73] No attempt is made in this Report to evaluate specific supply programs. Nevertheless, a number of comments can be made with regard to supply programs in general.

Supply side policies, by reducing the capital and operating costs incurred in producing and renting housing, lower the rents which must be obtained to induce investors to undertake new construction or to maintain the existing stock as rental housing. Such policies are self limiting because, as total supply increases, vacancy rates rise and the rents obtainable tend to decline. As a result, supply side policies tend to increase the availability of rental accommodation at the rent levels served by new construction and they tend to slow the rate of increase in the general rent level.

73. It would be extremely difficult, if not impossible, to carry out a reliable empirical comparison of programs since the effectiveness of each depends on housing market and economic conditions and many factors which cannot be measured, such as awareness of the program. In any case, the objectives of the programs differed since they were initiated under different political and economic circumstances.

Supply programs often are constrained so that only buildings containing certain types of units qualify for the subsidy. As a result the development of certain types of units, usually meeting minimum quality standards or maximum price limits, is stimulated.

It is evident from the housing policy perspective that the primary purpose served by supply side programs is to increase the availability of particular types of rental housing. It is important to recognize, however, that an important reason for the introduction of supply side programs is to stimulate the economy generally. Programs which encourage rental housing construction are seen as good methods of assisting the economy when unemployment is high and economic growth low.

Programs which stimulate production and increase ownership housing availability reduce the cost of new ownership accommodation and attract renters to purchase a home. Hence, ownership supply programs have an effect similar to rental supply programs on the overall rental market. Both rental and ownership supply programs increase rental availability generally, even if the program itself is restricted, because no segment of the market is fully isolated from the spill-over effects of programs which attract households to other segments of the housing market.

There has been considerable criticism of supply side policies particularly with respect to their use as a general economic stimulus. It is argued that these programs primarily advance the timing of supply. That is, units are built under the program to take advantage of the subsidies and financial inducements when they would likely have been built at some point in the future but without public expenditure. The increase in supply which may occur while the supply program is active will be offset by declines in construction after the program is terminated. As a result, there is no positive long-term effect on availability or affordability. Furthermore, if supply side programs were implemented on a permanent basis, there would be no incentive to accelerate construction in order to qualify for the subsidy; hence, even the short-run effect on availability would be small.

That criticism has merit. The inference is that supply programs can and should be used only to ease short-run shortages which may arise from unforeseen market conditions. As long as the purpose of the programs is to ease an immediate rental housing shortage, even if there is no long run effect, then a supply programs may be a suitable policy instrument.

Related to the preceding criticism is the concern that if there is no long-term effect on the supply of rental housing or the rent level, then the subsidies primarily increase the profits of the developers who were subsidized.[74] Tenants

74. The subsidies may be dissipated in increased property value, rather than in increases in new supply and resulting reductions in rent levels. See Gau and Wicks (1982).

will not benefit from lower rents. That result is not a problem if the intent of the program was to pay developers to accelerate their construction. However, if the intent was to make rental housing more affordable to tenants, it is evident that supply policies would work only if they were combined with controls on rents which might be charged for units built via a supply program.

Muller (1986) points out that to the extent supply programs increase vacancy rates, rent increases will be restrained and the returns to existing landlords will be held down. (p. 294) For older buildings occupying land which could be profitably redeveloped, demolition or conversion to other uses might be the result. This would further reduce the benefits of supply programs in terms of increased availability and lower rents. Some supply programs, such as a property tax reduction, will not have this effect as is noted in Muller. (1986, fn. 20, p. 244)

Other criticisms relate to the incidence of the benefits of supply programs. The benefits realized by tenants are not related to need since it is the general level of rent which declines. For programs such as those involving tax write-offs, the benefits go to higher income investors with tenants receiving little or no benefit. Whether that is the case or not, it is clear that the public's perception of who benefits may influence the political feasibility of adopting such programs.

3.2.1.3 Combined Demand and Supply Programs

Chant (1986) observes that some of the subsidy programs aimed at augmenting supply are difficult to distinguish from subsidy programs which augment demand. (p. 97) The programs in question are a sub-category of market augmenting policies and include the Assisted Rental Program, which has been phased out, and the Rent Supplement Program and the Private Assisted Rental Program still in operation. Operating or financing subsidies are paid to the landlord on condition that some or all of the units in the complex are rented to income-tested tenants. The shortfall in the rent payable by the tenants is covered by government subsidies to the landlord.

This type of market augmenting program would be most appropriate in circumstances which call for both demand augmenting and supply augmenting programs. For example, if government policy sought to house some households which could not afford the fair market rent for suitable accommodation in privately owned buildings, a demand augmenting policy would be appropriate. If it also was apparent that there was a shortage of a particular type of housing, a supply augmenting program would be required. Rather than implementing two separate programs, it could be more effective to have a single program which offers assistance for the development and operation of buildings which provided the required housing subject to the condition that a minimum percentage of units be rented to qualifying low-income households on a rent-geared-to-income basis. That would be a combined demand and supply program.

Combined programs have the advantages and disadvantages of supply and demand programs to a large extent. They provide direct assistance to households in need, and provide a more direct stimulus to the development of additional supply which meets criteria laid down by the government. Also combined programs could be structured to ensure landlords do not make excess profits as a result of the subsidy and that tenants get the full benefit of the assistance, even in the absence of a market-wide system of rent regulation. Further, a combined policy is more effective in ensuring those in need benefit from the program than would be the case with a supply program which might be used to build units those households most in need cannot afford.

The primary disadvantage of combined programs is that they offer tenants less flexibility than a shelter allowance since assisted households would be restricted to the buildings which participated in the program. However, if a combined program were implemented on a large enough scale, then after a few years it could be possible to offer a reasonable degree of flexibility in meeting the individual needs of assisted households.

3.2.2 Market Replacing Programs

The basic distinction between supply augmenting programs and market replacing programs is the nature of the supplier of the housing. The suppliers of market replacing programs include government and government agencies who provide socially integrated and public housing, and the "third sector" in the housing field, namely non-profit and cooperative organizations. The motive of these suppliers is not return on investment or profit but rather to provide housing to particular groups within society, generally at a price which is subsidized so that tenants pay less than the fair market price.

The principal difference between the long-standing public housing programs and the more recent non-profit and cooperative programs is in the extent of income integration among tenants. In the former, virtually 100 per cent of tenants paid rent on a geared-to-income basis. Under the latter there has been a mix of tenants by income levels with the majority paying a lower end of market rent and the balance of units available for lower income tenants on a rent-geared-to-income basis.

A difference of approach between the federal and Ontario governments is apparent in how funding for social housing should be spent. The most recent indication of federal policy is found in the statement made by the Minister of Housing in the House of Commons on Dec. 12, 1985. He said:[75]

75. Details of the policy outlined in the Minister's statement are provided in a brochure published contemporaneously entitled *A National Direction for Housing Solutions*.

> . . . the federal government will provide a new package of social housing programs *with all assistance directed to households in need*, that is, those which are unable to obtain affordable, suitable and adequate accommodation in the private market. This represents a significant improvement over previous programs, under which only about 1/3 of the total units provided went to households in need, and which enabled us to reduce the level of outstanding need by less than 2% per year.
>
> The new non-profit housing program will be used to increase the supply of affordable units. . . . *assistance will be directed to households in need*. (Honourable Bill McKnight, 1985, p. 3 emphasis added)

The provincial Minister of Housing in an address to the Ontario Municipal Non-Profit Housing Conference in September, 1985, presented a conflicting viewpoint:

> This [the federal government] approach is not acceptable. We know from our experience and from discussions with non-profit groups that a non-profit program targetted to core need will create difficulty in terms of community acceptance.
>
> As a federal policy it will not serve the needs of this province. We are determined to ensure that socially integrated housing remains a key to our social housing programs.
>
> I want to assure you that Ontario believes that income integration must remain a central principle for the program, and that *no change* will be made to the rent-geared-to-income scale. (emphasis in original)

The Minister's position is indicated by the emphasis placed on socially integrated housing in which housing will be available for both low and moderate income households.

The difference between the federal and provincial approaches to socially assisted housing may not be as significant as the statement by the provincial Minister might indicate. A release dated Dec. 16, 1985, from the Ontario Ministry of Housing indicates that only 20 per cent of the population of an integrated housing project would pay market rents.

There is little doubt that given the limited funds available for social housing, a larger number of households which cannot afford fair market rents can be assisted if socially assisted housing projects are not integrated. On the

other hand, there also is little doubt that the quality of the housing environment is better in integrated housing.

From 1949 to 1976, most socially assisted housing took the form of public housing but that approach has met with serious criticism for the last two decades. For example, Dennis and Fish (1972) recommended that the:

> . . . public housing program in its present form (the construction of new, highly-subsidized units to be owned by the public and occupied only by the poor) be abandoned. Some of the reasons for doing so are contained in our review of program performance: poor locations found for residential housing; problems of design caused by cost cutting or attempts to build outstanding housing for the poor; high density, high cost housing dictated by cost concerns; insensitive management that treats public housing tenants as welfare clients; the negative attitudes of administrators, surrounding neighbourhoods, and the public generally.[76]

In spite of criticisms, the public housing program has been considered by some to have been successful in delivering affordable and adequate accommodation for those whose needs could not be met in the private market.[77] The problems were attributed to the concentration into one area of many families with problems and large numbers of children.[78]

In the 1970s there was a shift away from public housing. Instead the objective of providing housing low and moderate income families could afford was pursued by means of programs which also achieved a mix of tenants by income levels. Using that approach, non-profit and cooperative projects avoided many of the problems associated with the older public housing projects.

Although there are important differences among the various types of market replacing programs, several general observations are possible. All types are intended to direct assistance to particular households which qualify for it in the form of adequate housing provided at subsidized rents. The latter feature differentiates market replacing programs from demand programs. It is a way of ensuring that the assisted households live in adequate housing. With a cash subsidy, some households may choose to live in substandard dwellings and

76. Dennis and Fish (1972, p. 218) as quoted in Chant (1986, p. 349).

77. For example, as cited in Chant (1986, pp. 321 and 350), see British Columbia (1975, p. 238), the Association of Municipalities of Ontario (1982, p. 3) and the Canadian Council for Social Development (1977, p. 69).

78. The Canadian Council of Social Development (1977, p. 160) as quoted in Chant (1986, p. 348).

spend the cash in other ways — which may be something socially acceptable such as adequate food or something else which is considered to be inappropriate. Whether controlling the housing consumption of subsidized individuals is desirable or not is essentially a political question. However, several criticisms of the market replacing approach should be considered, namely: effects on rents and supply, equity effects, program costs and efficiency effects.

Market replacing programs involving new construction lead to an increase in supply and availability. Muller (1986) comments that as a result, households will be drawn away from the private market. (p. 262) This should restrain private sector rent increases. However, as a result of a decline in demand for privately supplied units, fewer private units will be built and, possibly, some private producers will withdraw units from the market through conversion and demolition so that the net increase in total supply is something less than the number of units built under the market replacing program. To the extent that private supply declines, the socially assisted housing will replace, not augment, private supply and the effect on availability and rents in the private market will be reduced.

Muller (1986) states:

> Public housing supplied from new construction tends to depress rents, especially in those segments of the housing market providing similar accommodation . . . If the market for rental housing is strongly segmented regionally and by income, a major public housing project could have quite noticeable effects. This improvement in affordability will be eroded as the private stock is withdrawn from the market, but if there are strict local controls on conversion and demolition the lag may be substantial. (pp. 272-273)

In this vein Chant (1986) comments:

> To the extent the housing market can be segmented, housing which would have been directed toward low income tenants will most likely be displaced by public housing. (p. 342)

Comay (1984) observes that for Cityhome buildings,[79] low end of market rents under the non-profit and cooperative programs have been set in relation to comparable, private sector, non rent-controlled rental housing in the vicinity. He suggests this practice results in Cityhome rents being pegged to new or relatively costly private units, particularly since many Cityhome units are located in central areas where private rents are high. He contends the lower

79. Cityhome is the City of Toronto's non-profit housing corporation.

end of market rents in newer Cityhome units are beyond the reach of moderate income families. (p. 14) That does not imply, however, that they exceed the fair market rent for those units.

A different concern arises when existing private sector rental housing is purchased for market replacing programs because it reduces private sector supply.[80] This could reduce availability and increase rents for the type of unit purchased. However, to the extent that the socially assisted units draw households away from the same segment of the private market, the effect on private market availability and rents is not significant.

Under the older public housing programs, the benefits were realized by those members of the low-income group obtaining accommodation. As Chant (1986) notes, the benefits of the subsidy element in public housing programs are confined to tenants with low incomes:

> Households which would have had incomes below $21,000 in 1980 accounted for 95 per cent of recipients of benefits from public housing... (p. 359)

In the newer programs the degree of income integration affects the number securing affordable accommodation. In the non-profit and cooperative program, in 1980, only 66 per cent of households in these units had household incomes below $20,000. The existence of extensive waiting lists for rent-geared-to-income housing provides some indication that all those in need are not accommodated by the programs. This outcome is more noticeable under the non-profit and cooperative progams as fewer households in need can be accommodated in a given project. Muller (1986) observes that while the non-profit and co-operative programs have been successful in integrating rent-geared-to-income and other tenants:

> . . . this has been achieved at the cost of providing as many as three subsidized units for middle income families (who pay ''lower end of the market'' rates) for every unit constructed for low income families. (p. 277)

Chant (1986) comments:

> Thus from an equity standpoint, it can be argued that the section 56.1 program [non-profit and co-operative programs under the Na-

80. If ownership housing is purchased and converted to rental it would represent an increase in supply which would tend to moderate rent increases and short term availability effects (Muller, 1986, pp. 266-267).

> tional Housing Act] supply quite substantial benefits to participants but do not concentrate these benefits to low income groups and affect the affordability of housing for only a minor portion of target households. (pp. 359-361)

The costs involved with market replacing programs are considerable and compromise other social goals although Muller (1986) notes the costs could be reduced if more emphasis was placed on the purchase and renovation of existing housing. The non-profit and cooperative projects have the lowest subsidies per unit supplied under the program but highest subsidies per rent-geared-to-income unit compared to alternative programs.[81]

Comay (1984) notes that in Cityhome units built under the section 56.1 program, low end of market procedures which are used to determine rent increases in addition to base rents, result in increases beyond the influence of the landlord or tenants. He suggests the "mechanism effectively precludes any serious incentive for cost saving practices on the part of either tenants or building management." (p. 22)[82]

The benefits accruing to tenants from market replacing programs can only be obtained by occupying units in designated projects. This may have some negative efficiency effects in terms of the mobility of households which may lose the benefits if they move unless there is subsidized accommodation available in their new location. Also, under a public housing policy which requires tenants to qualify for admission, an increase in income above a certain level will result in the tenant being forced to leave.

3.3 Institutional Policies

Chant (1986) defines institutional policies as follows:

> Institutional policies establish the ground rules under which housing can be supplied. They consist of the set of rules which delineate acceptable or legal forms of behaviour by suppliers from unacceptable or illegal [behaviour] in all dimensions except rent. These rules govern who is permitted to participate in the market, what products

81. See the CMHC (1983) *Evaluation* study cited by Chant (1986, p. 361-363).

82. Several studies suggest that government produced and operated housing is more expensive than similar accommodation provided by the private sector. That evidence is reviewed by Chant (1986, pp. 337-342) and Muller (1986, 93-98, 279-80). The City of Toronto's non-profit housing program under Cityhome has recently begun joint ventures with the private sector for the construction and management of non-profit housing.

> or services can be supplied and the conditions under which they can be supplied.
>
> For the housing market, two major types of institutional policies can be distinguished:
> 1) those governing the relationship between landlords and tenants,
> 2) those which limit the types of rental housing supplied on the market. (pp. 101-102)

Institutional policies encompass a broad area, from the landlord-tenant relationship to the physical aspects of the housing market: zoning, height and density bylaws, construction standards, health and safety requirements and occupancy limits. They serve two purposes:[83] 1. consumer protection and 2. community enhancement or protection.

The rules set down by the Landlord and Tenant Act regarding such matters as the terms of eviction and responsibilities of landlords have an indirect effect on the market in that suppliers say such restrictions do tend to inhibit their participation in the market. More direct effects of institutional policies result from the physical restrictions imposed on rental accommodation and land use by the various levels of government.

Institutional policies, particularly those aimed at consumer protection, are a necessary facet of the rental market. Higher standards and more diligent enforcement can be expected and are welcomed. However, like so much else, there is a price to pay for both the increasing standards required of new construction and the restrictions on conversion known as community enhancement or protection policies.

These latter policies are devised to maintain standards within a given community or area. Zoning, density and height restrictions can make it impossible either to build new rental accommodation or convert existing structures into multi-unit rental apartments, flats or rooms. The result is to ensure existing residents of their neighborhood's continuing ''character'' or aesthetic standards while, at the same time, imposing a barrier to prospective residents.

Like community enhancement policies, consumer protection standards impose another penalty on the rental population, most particularly those at the low-income income level of the market. Structural and safety policies, if required for older buildings (which normally offer low end of the market rents), can force some low-grade but still functional housing out of the market. Social

83. Economists call these reasons market imperfections. They arise because transaction costs, particularly the cost of information, are not negligible and because new housing developments may have external costs and benefits which impact on the community generally.

policies regarding crowding also can reduce the amount of housing available to needy tenants.

New construction standards also add to the problem of low-income households. While aimed quite correctly at giving consumers safer and better quality housing, these standards call for greater financial outlays on the part of suppliers which, in turn, increases the amount of rent required to make construction of the building economically feasible.

In all cases, it is the affordability problem of low-income households which is aggravated. Hence, budgetary policies are required to assist these households so they can afford the rents associated with the enhanced housing standards which require substantial capital outlay on the part of landlords.

So far as compliance by landlords with normal on-going housing standards is concerned, they must be permitted to charge rents at the fair market rent level so they will have rental income adequate to pay the costs of meeting housing standards. As long as rents do not exceed the fair market rent level, landlords can receive adequate compensation while maintaining rents which are fair to tenants. However, in order that low-income tenants will be able to meet those rents while paying only a socially fair rent, a shelter allowance program will be the only way to make their housing affordable to them without requiring them to move to a designated assisted unit, if a suitable one is available.

Governments have set for themselves the goal that every household is entitled to decent, adequate housing at a rent affordable by it. Therefore they must accept the financial responsibility of covering the gap between the rent the tenant can pay and the rent the landlord should receive, if — as the Inquiry maintains it should — the private market is to be the main supplier of rental housing. The alternative is for government to assume the cost of providing socially assisted housing on a scale which will meet the housing goal.

3.4 Concluding Comments

The programs available to governments as responses to the problems discussed in Chapter 4 are of three types: rent regulation programs, budgetary programs and institutional programs. All three program types affect the rents tenants pay. From among the various programs, specific programs or a combination of programs can be chosen to have virtually any desired effect on rent levels, supply and private sector profitability.

Of the three categories of housing programs, rent regulation is of the most direct relevance to the Inquiry. Several conceptually distinct systems are considered. Three forms of rent review, namely cost pass-through, rate base-rate of return and market comparison are examined in some detail, as is rent control.

Other features of rent regulation schemes, such as whether they are restrictive or moderate and whether they are mandatory or optional, also are examined.

The alternative approaches to rent regulation are evaluated in light of the fair market rent concept developed in Chapter 2. It is apparent that if private investors are to contribute in an adequate way to maintaining and enhancing the supply of rental housing in Ontario, the pressure to hold rents down in privately financed buildings must yield to the reality that investors will look to opportunities in other sectors of the economy unless they can anticipate receiving a fair market rent for the units they provide. A system of rent regulation should not be restrictive which means that rents are not held below the fair market level. It is legitimate, however, that a non-restrictive and hence moderate system should restrain rents from exceeding the fair market rent level in the long run. The system which will offer the greatest benefit to tenants without precluding adequate private investment in the rental housing market is one which will allow landlords generally to earn the competitive rate of return on their investments.

It can be a feature of a rent regulation system that landlords and tenants have the option of negotiating an agreement on what the rent or the rent increase should be. A rent arrived at in this way ordinarily could be expected to be a fair market rent. However, the landlord and the tenant who engages in negotiation is protected against being overborne by some economic or personality superiority of the other by having the unrestricted right to break off negotiations and have the matter decided by the regulatory authority. A system with this feature is described as optional. A system where the rent is decided by the regulatory authority with no option to negotiate is referred to as a mandatory system. A system with the option feature has advantages in the form of expediting the rent setting process and minimizing tensions between landlords and their tenants.

With regard to the rent review feature of a system of rent regulation, as distinguished from rent control, the Inquiry is critical for a number of reasons of the cost pass-through system as it has operated in Ontario since 1975. Briefly stated they are:

1. It assumes the initial rents to which increases are added are fair, which is not always the case. Moreover, as time passes, rent differences between units of similar value will be accentuated. The resulting rents can be prejudicial over the long term to landlords if they are on the low side and to tenants if they are on the high side.

2. The allowed cost pass-through may not reflect the amount by which fair market rent has increased because the required return on equity component of the fair market rent is not considered.

3. There is no way of equalizing rents for similar units in different buildings. As a consequence, the rents paid by different tenant households are not equitable across the rental market.

4. Passing through increased costs without any examination of their justification leads to inefficiency and unnecessary increases.

The Inquiry considers cost pass-through rent review to be a satisfactory "blow-off valve" for a restrictive system of rent control implemented on a temporary basis[84] but, in the long run, it is not equitable or satisfactory.

The rate base-rate of return system determines allowed rents rather than allowed rent increases. It takes into account the fairness of the initial rent level as well as the amount of the increase and does not lock the landlord into a return which may be high or low relative to the competitive rate of return. For those reasons it is superior to the cost pass-through system but because it sets rents on an individual building basis, it cannot ensure that the industry is charging fair market rents.

The changes introduced in the 1986 Act give explicit recognition to rate of return for post-1975 buildings which undergo rent review, bringing the process closer to a rate base-rate of return system; but it remains deficient relative to a comprehensive rate base-rate of return system. There are four important reasons for this being the case:

1. in only a small proportion of Ontario's total rental stock will rents be set on this basis;

2. return on equity can be used to increase the allowed rent, but not to decrease it if the rent is excessive;

3. the allowed rate of return has not been determined in a manner which ensures that it corresponds to the competitive rate of return for investment in rental housing; and

4. the method of determining the rate base is not consistent with the principles discussed in section 3.1.3.2.2

In addition, many of the lesser problems with the cost pass-through approach have not been corrected.

Even if the Ontario system further evolves to make it a true rate base-rate of return regulatory system, it would still not succeed in setting fair market rents in the marketplace. It would be necessary to base rents on standardized rather than actual costs in order to ensure that rents for different tenants in

84. The 1975 Act that launched rent regulation in Ontario came into force as of August 1, 1975 and as originally passed by the legislature, was to have expired on December 31, 1977.

similar units are equitable even if their landlords incur different costs in running their buildings. This requires setting rents on an industry-wide basis rather than on a short term building-by-building basis and the rate base-rate of return system is not designed to set rents in this way.

In any case, the rate base-rate of return approach to rent regulation would be an administrative nightmare. Problems would arise in determining the appropriate standard costs to use in individual cases, and the determination of the appropriate rate base could only be done at disproportionate expense. If the system were not modified in some way it would require elaborate hearings for every complex and moreover they would be beyond the capacity of many landlords to handle. On the other hand, a too simplified rate base-rate of return system would compromise the system's conceptual intent and inevitably would result in rents being set for some units which were significantly different from what was intended.

Market comparison is the third alternative form of rent review to which consideration is given in this Chapter. Market comparison is effective as a means of reducing the variations in rents for similar units but it cannot be used to change the general rent level in the housing market. If the rental housing market is competitive, so that the rent level is at the fair market level, the market comparison method of setting individual rents would set fair market rents. However, rents have been depressed to below the fair market level. Given those conditions, market comparison rent review would not establish fair market rents in itself.

Rent regulation in the form of rent control has the advantage of administrative simplicity and minimal transaction costs for landlords and tenants. The guideline limit or rate should be responsive to changes in market conditions, however. This can be effected as part of the scheme if there is a means of adjusting the guideline at fixed or discretionary intervals. The guideline should reflect average increases or decreases. In that connection it is pointed out that rent control standing alone should not be criticized for treating all landlords the same, regardless of their financial circumstances. It is not a requirement of fairness that a regulatory system should cause all landlords to be equally profitable. As long as investors in general are able to earn a fair return on average, it would be fair if their actual returns do vary depending on their individual success in controlling costs, as would be the experience for investment in an unregulated market. Rents should be set as they are in a competitive market, that is on the basis of value to the tenant. As a consequence, landlords would receive similar rents for similar units without regard to whether their costs and hence their returns are above or below the average.

What is required for a rent control guideline is that it reflect the rate of change in the level of fair market rents. It should be as low as possible for

the protection of tenants but not so low as to discourage private investment in rental housing.

Budgetary programs have functioned in Ontario for more than 50 years to serve various purposes including stimulation of the economy, relief of unemployment, increased supply of rental housing and provision of housing for low-income tenants. Programs have been classified as market augmenting in which payments are made directly to tenants, landlords or developers, and market replacing in which government takes on the role of landlord/developer. The former break down into demand and supply programs. Demand programs such as shelter or housing allowances both have the merit of putting money into the hands of tenants who need assistance without delay and treating equitably those households entitled to relief. Demand programs are criticized as forms of welfare payment and for not ensuring that any more housing will be built. Since the problems of low-income households relate primarily to the fact that too much of their income is required for rent, not that their housing is sub-standard, that concern should not be an obstacle to introducing a shelter allowance program. It is also said as well that only landlords profit from shelter allowances. However, in an environment where rents are regulated, that concern is not valid. Regardless of the pros and cons for shelter allowances, one fact is clear. Until subsidized housing is available to all households which qualify for assistance — and that will not be the case in the foreseeable future — some form of housing allowance is the only way to ensure that all qualifying households receive some assistance. Hence, without a shelter allowance, households requiring assistance cannot be treated equitably.

The other form of market augmenting programs are supply programs which take the form of subsidies, loans and concessions to developers and builders to increase the rental housing supply. There are also combined demand and supply programs under which operating and financing subsidies are paid to landlords who must provide some units at below market rents for low-income households or special need groups. Market replacing programs, as the name implies, fund government agencies and third sector organizations to build and operate non-profit housing. There is some difference of opinion between the federal and Ontario governments as to whether all or only part of this housing should be occupied by tenants who pay low end of market rents.

The third main category of housing policies are institutional policies which govern the landlord and tenant relationship and set standards of quality, construction and safety applicable to all rental housing.

Chapter 4

The Objectives of Rent Regulation

The Inquiry has been conducted and this Report has been written on the basis that a viable, private component of the rental housing market[1] is a necessary feature of the economic and social fabric of Ontario. It is accepted as well that government intervention in the operation of the private market is necessary to achieve social outcomes the community regards as desirable. However, it also is recognized that while well designed government programs can provide significant social and economic benefits, poorly designed programs may fail to realize those important social objectives which are the rationale for intervention. In fact, poorly designed programs can disrupt the operation of the market in ways which are detrimental to many of the people they were intended to help. The costs and detrimental consequences of the Ontario system of rent regulation in place since 1975 are identified in Chapter 1.

In order to determine the most suitable system of rent regulation for the Ontario rental housing market, it is necessary first to have a clear understanding of the problems in the market requiring attention and of what rent regulation can do for them. There are three types of problems. First there are the problems which at least some people consider to be characteristic of unregulated rental housing markets which provide the rationale for intervention in the first place. Second, there are problems which have resulted from the rent regulation system in place in Ontario since 1975. They provide the rationale for changing the type of rent regulation system used in Ontario. Third, there are additional public policy constraints such as spending restrictions and general issues of

1. The rental housing market may be said to consist of a private sector in which neither landlords nor tenants are subsidized, a public sector in which the supply is financed by government and an assisted sector in which landlords, tenants or both are subsidized.

equity which must be taken into account when developing policies in any sphere of government activity.

The Inquiry has classified problems of the first type as follows:

1. the affordability of rental housing,
2. excessive rent charges,
3. a high rent level on an on-going basis as indicated by excess industry profits,
4. rapid increases in rents due to changing rental housing market conditions,
5. security of tenure, and
6. substandard housing.

Problems which have arisen largely as a consequence of rent regulation in Ontario since 1975 are:

7. availability of capital,
8. availability of rental housing, and
9. reduced maintenance and conservation.

A final section is added which discusses issues with regard to general public policy constraints.

No system of rent regulation can be expected to respond effectively to all the issues examined here. Consequently, this Chapter draws on Chapter 3 which discusses not only rent regulation, but also other types of policies and programs available to deal with the rental housing market problems.

The objectives of rent regulation are defined by identifying those concerns for which rent regulation is the appropriate policy instrument. Rent regulation is not a suitable policy response for some of the issues discussed in this Chapter. They are identified and alternative responses are considered.

Chapter 2, which examines views of fair rent, provides essential background for determining which problems can be adequately dealt with by rent regulation. Rent regulation cannot solve problems which arise because the cost to landlords of supplying rental housing exceeds the amount some households reasonably can be expected to pay. The problems which can be dealt with by rent regulation are those which arise because the rents being charged by landlords exceed fair market rents. Fair market rent as defined in Chapter 2 is accepted by the Inquiry as the only practicable criterion for determining whether the rents being charged for privately-owned rental units are fair. Hence, the

problems which rent regulation can be used to resolve are those which arise when the actual rent being charged for a unit deviates from the fair market rent. Problems which arise even when rents are fair can only be resolved by means of the alternative programs discussed in Chapter 3.

Chapter 5 proposes the Fair Market Rent (FMR) system of rent regulation which responds to the various problems which involve deviations of actual rents from fair market rents. The objective of the FMR system of rent regulation is to ensure that the rent actually charged for each unit in the private market is a fair market rent. This Chapter sets the stage for Chapter 5 by developing a clear understanding of the objectives of rent regulation.

4.1 Affordability of Rental Housing

The popular approach to the issue of affordability[2] is simply that rents are too high and if they were held down they would be more affordable. This is a truism and approached in this way almost every tenant household, even those in luxury suites, who thought their rents were too high, could claim to have an affordability problem. To discuss the problem in those terms is to trivialize it. There is however a general attitude among tenants that their rents should be more affordable, that is to say, they should be cheaper. But the essential question is how cheap can rents be, given the economic realities of the Ontario housing market. The answer to that question depends on whether or not rents are subsidized. If subsidies are to be used to reduce rents, then the further question of who society is willing to subsidize must be addressed.

It is evident that rents which are not subsidized can be no lower than the fair market rent level without bringing about the problems related to capital shortages discussed in Chapter 1.[3] Hence, only those rents which are greater than fair market rents can be reduced without creating problems. Two situations can be envisioned in which a household's rent would be above the fair market rent for its unit.[4] The first is that although rents generally may be at or below the fair market rent level, a particular landlord may charge an excessive rent and a household may pay the rent demanded rather than incur the sometimes

2. The term affordability has great currency in residential tenancy circles but it will not be found in any dictionary, legal or otherwise. Taken literally it means ability to afford and it is meaningless to refer to a rental housing unit as being intrinsically affordable or unaffordable. Every unit is affordable to some households and not affordable to others. Each household's view of affordable housing is determined primarily by what is affordable to it.

3. The reason why capital shortages arise when rents are below the fair market rent level are discussed in Chapter 2 and in section 3.1.1.1, restrictive regulation.

4. For examples, see the testimony of E. Frerichs, S. Peters, Transcript 30; and S. Goetz-Gadon (in cross examination of W. Stanbury), Transcript 100-2.

prohibitive cost and inconvenience of moving. That is a special problem which is discussed in section 4.2 below under the heading of excessive rent charges.

The second situation is that rents generally may be above the fair market rent level. Section 4.3 below addresses the question of whether that is an on-going feature of the rental housing market. If it is, then it will be evidenced by excess profits in the industry. Even if the general rent level is not high on an on-going basis, there is the possibility that under tight market conditions rents will increase rapidly to a level which is excessive relative to the usual rent level. It appears this type of situation occasionally develops in a growing market because the demand for housing sometimes outruns the development of additional supply of housing due to economic and political factors. That type of high rent situation is examined in section 4.4, below.

The situations examined in sections 4.2, 4.3 and 4.4 account for all the circumstances where rents can be reduced without the rent being subsidized and without detrimental consequences for the rental housing market. In each case the rents for at least some households can be reduced because they are above the fair market rent for their units.

Although those conditions clearly have an impact on the affordability of the housing occupied by affected households, they do not give rise to an affordability problem as that term is used in this Report. A household is considered to have an affordability problem if it cannot reasonably afford adequate housing, even if adequate housing suitable to its needs is available at a fair market rent. The real problem facing households with an affordability problem, using that definition, is not that rents are too high, but that their incomes are too low given the fair market rent for suitable accommodation. The distinction may seem tenuous to households having difficulty paying the rent they are being charged. But from a policy viewpoint, the distinction is critical since policies which are effective in correcting the problem of rents being above the fair market level are counter-productive when used as a response to an income-related affordability problem.

4.1.1 Affordability as an Income Problem

Three general conclusions emerge from the analysis of the magnitude of the affordability problem examined in Appendix C:

1. there are several different criteria which can be employed to determine the rents households can afford to pay;

2. measures of the magnitude of the affordability problem depend on the criterion used and while all the generally accepted measurement techniques show that a significant number of renter households

have an affordability problem, they are in every instance a minority of all renters; and

3. whatever criterion is used, the principal cause of an affordability problem is low household income.[5]

Of the several problems identified in this Chapter which arise in unregulated rental housing markets, the affordability problem is the most serious one in terms of the number of tenant households adversely affected and the severity of the hardship caused. Furthermore, it is evident that Ontario's system of rent regulation has done little to alleviate the problem for those households with the most severe affordability problem. Other programs, such as the provision of socially assisted housing, have done much more to ease the affordability problem of low-income households but the majority of households requiring assistance do not receive sufficient benefits to alleviate their affordability problem. Much remains to be done before this problem for Ontario's renters is resolved.

One reason for the failure of existing policies may be that the affordability problem has not been defined clearly enough. On the conceptual level that is because it is confused with problems related to actual rents being above fair market rents.

On a more practical level, difficulties arise because a household's affordability problem cannot be isolated from its overall affordability, or income, problem. When a household has insufficient income to afford, in adequate measure, all of the basic necessities of modern social living, it is misleading to focus on one component of the household budget, namely rent, even if it is the largest single monthly expenditure. One household with low income may pay the rent necessary to have adequate housing, but not have enough money left over for decent food and clothing. Another low-income household may live in inadequate housing in order to keep its rent low enough to have enough money left over for adequate food and clothing. It could be argued that only the first household has a housing affordability problem because only it is paying too much for adequate accommodation. On the other hand, it could be argued that only the second household has a housing affordability problem because only it lacks the funds to obtain adequate housing. If the latter position is taken, it would follow that the first household has a food and clothing affordability problem because it cannot afford decent food and clothing. Does that imply that the second family does not have food and clothing affordability problems?

5. However, if the rent-to-income ratio is used as the affordability criterion, affordability problems also may result from lifestyle decisions.

The Inquiry's view is that such arguments miss the point. Whatever can be said about the circumstances of the two households, one fact stands out: neither is able to afford decent accommodation, food, clothing and the other necessities of life. It seems to the Inquiry that attempts to isolate and measure the housing affordability problem of low-income households are arbitrary and insensitive to the real needs of those households. Whatever is done about their housing problem, they will still be paying too much for housing as long as they have insufficient income left over for all other needs.

The reason why policies which focus on housing affordability are nothing more than a partial solution to the general affordability (or income) problem can be illustrated by an example. It could be a government policy or the policy of some social agency that a household requires $300 per month for rent and $900 for all other expenditures (a total of $1200 monthly). If its income is only $1000 per month, it could be said that the household has a general affordability problem which amounts to $200 per month. To reduce the actual net rent paid by the household to $250 (25 per cent of its income, a commonly used criterion of housing affordability) by paying it a shelter allowance of $50 a month would not resolve its general affordability problem. It still would have only $1000 to pay $1150 in monthly expenses net of the allowance. To say that this level of assistance would eliminate the household's housing affordability problem simply reflects the fact that if the income shortfall is allocated proportionately to all items in the household's budget, the assistance provided equals the housing share of the shortfall. From the point of view of the household economy there is no difference between eliminating the housing affordability problem and reducing the total affordability problem by 25 per cent. Thus it can be said that however the housing affordability problem is defined, any program designed to relieve that problem alone, in reality works out as a program which only partially alleviates the total affordability problem. In fact, the household cannot be said to be able to afford adequate housing as long as it has insufficient income to pay for adequate housing as well as all other basic needs.

When looked at in this way, it is evident that the appropriate policy response to the affordability problem would be a general incomes policy. The Report of the MacDonald Commission[6] provides a thoughtful examination of that response. It is beyond the mandate of this Inquiry to examine in detail reforms which respond to the problems related to low-income in general. Nevertheless, it is clear to the Inquiry that until the housing affordability problem is approached from this perspective, it will not be resolved.

6. See Chapter 19 of the Report of the Royal Commission of the Economic Union and Development Prospects for Canada, 1985.

Stating the problem in this way highlights the dilemma which is continually faced in the formulation of housing policy. The key consideration in designing housing affordability programs should be to ensure that as much as possible is done with the limited resources available to ease the broader income problem of low-income households. That approach is appropriate because the only reason for recommending housing affordability programs is that, in the absence of a comprehensive solution to the income problems of low-income households, a partial solution is better than none.

Since there is little likelihood that a comprehensive incomes policy will be implemented in Canada in the foreseeable future, it can be expected that housing affordability policies will continue to be used to provide some measure of relief to low-income households. In this Report, no attempt is made to choose among the arbitrary definitions of what constitutes a housing affordability problem. Instead, the concept of socially fair rent introduced in Chapter 2 is used in a generic sense to identify a rent which society deems a household can afford to pay. In practical terms, the criteria used to determine levels of assistance provided by government programs implicitly define what is deemed to be the socially fair rent limit of the households affected by the programs. Whatever criteria are used, this Report uses the term affordability problem to refer to a situation where, in the absence of government assistance, the fair market rent for decent, adequate accommodation would exceed a household's socially fair rent limit.

4.1.2 Policies for Relieving the Affordability Problem of Low-Income Households

Housing programs of many different types could provide some measure of relief to low-income renter households. In order to achieve that result, however, it is unavoidable that society bear some costs. Whenever a disadvantaged group is assisted, someone must pick up the tab. The following sections evaluate the benefits and costs of using rent regulation compared with the other types of programs discussed in Chapter 3 as a means of alleviating the affordability[7] problem of low-income households.

4.1.2.1 Rent Regulation

In theory, setting rents for private sector units which do not exceed the socially fair rents[8] of households occupying those premises would resolve the housing

7. Affordability criteria are discussed in Adams, Ing and Pringle (1986, pp. 117-125); Fallis (1984, pp. 26-29); Marks (1984, pp. 8-10 and 25-41); Pringle (1986, pp. 116-122); Stanbury (1985a, No. 15), pp. 2-36 to 2-38) and Steele and Miron (1984, pp. 2-11).

8. There is room for endless debate regarding the criteria which should be used to determine

affordability problem of those households. However, to base rents in the private rental market on what households can afford to pay without regard to landlords' costs is clearly not feasible. Private landlords must receive a fair return on investment or there will be no investment in rental housing. It would be unfair to landlords to expect them to bear the full cost of society's decision to assist low-income tenants in this way even if their investment could be locked into the rental housing market. The cost of such a program should be borne by taxpayers generally.

The only way a regulatory scheme could hold rents down to the socially fair level for low-income tenants — without government subsidies and without landlords paying the cost — would be to offset the low rents charged to low-income households with high rents charged to high-income households. In other words, high-income tenants would bear the cost of subsidizing low-income tenants. That approach also is not workable because high-income households would quickly leave the rental market.

In a July, 1982, MMAH study, *The Impact of Rent Review on Rental Housing in Ontario*, Ministry staff express the view that, ". . . rent review cannot be viewed as an efficient means of approaching the affordability problem." The study says:

> It is self-evident that, if one defines affordability in terms of the ratio of rent-to-income, a policy that works to hold down the rate of rent increase may well have an impact on affordability problems. It follows that one can evaluate rent review from the perspective of its contribution to the resolution of affordability issues. It does not however follow that rent review is solely or primarily an instrument aimed at improving affordability . . .
>
> It may be well to reflect at the outset on why rent review is not, and cannot be designed with the focus on improving affordability. The reason rent review cannot be so designed is that any attempt to include tenant income in the determination of rents would impose severe financial hardship on landlords renting to those with low incomes. Rent revenues would fall and, therefore, in many instances profits would be squeezed to the point of elimination or loss . . . (p.118)

It is clear that as long as the private sector is to be the major supplier of rental housing, there is no practicable alternative to permitting landlords to

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whether the rent a household pays is socially fair, but there is no analytic base on which the Inquiry can pass judgement on alternative points of view. Socially fair rent is what government deems it to be. The analysis and recommendations contained in this Report are not affected by the criteria used for determining whether a rent is socially fair for a particular household.

receive the fair market rent for all units regardless of the income of the tenant household. As a consequence, rent regulation cannot resolve the housing affordability problem of low-income households.

Despite the obvious incapability of rent regulation to provide adequate assistance to those low-income households which require it, rent regulation continues to be advocated on the ground that it provides some relief. In particular, it is argued that by reducing rent by several percentage points, the restrictive system of rent regulation in Ontario has done something to relieve the affordability problem of lower income households. Some households in the marginal area where the socially fair rent limit is just below the fair market rent for decent housing may no longer have an affordability problem, as measured by standard affordability criteria. However, only a small fraction of the total renter population comes within that marginal class. Middle and upper income households whose socially fair rent limit is greater than market rent for suitable accommodation do not have an affordability problem. There is no justification for holding their rents even marginally below the fair market rents for their units. On the other hand regulation which reduces rent levels by a few percentage points is a woefully inadequate policy for relieving the affordability problem of households whose socially fair rent limit is well below the fair market rents for suitable accommodation.[9]

It is evident that while a rent regulation system which holds rents below fair market rents will significantly reduce the payments made to landlords from tenants, relatively little of the resulting tenant benefit will actually accrue to low-income tenants. The fact that all tenant households benefit may make a restrictive rent regulation system popular, but it does not make it an effective measure for assisting low-income households. As a measure for relieving the affordability problem of those tenants, rent regulation is as illogical as basing welfare payments on the rent households pay rather than on their incomes.

From the viewpoint of its costs, rent regulation looks no better as a policy for relieving the affordability problem than it does from a consideration of the benefits it provides. The discussion in Chapter 1 of the consequences of Ontario's system of rent regulation and the discussion of restrictive rent regulation in Chapter 3 both show that a rent regulation policy which holds rents below the fair market rent level causes severe problems. Those problems are inevitable

9. As shown in Appendix C, estimates of the number of Ontario households paying more than 25 per cent of their income in rent vary from 162,000 to 421,000 at different points during the 1978-1984 period. Based on data in Miron and Cullingworth's study (1983) on the affordability gap of households, 87.5 per cent of the 242,000 households they estimated had an affordability problem in 1978 would still have been paying more than 25 per cent of their income if their rent were reduced 10 per cent — the amount by which rent regulation has been estimated to have reduced rents. Also see Stanbury and Vertinsky's (1986) discussion of the incidence of the benefits of rent regulation.

because investors will go elsewhere if they do not anticipate being able to make a competitive return on investment in rental housing. It should not be surprising that when rent regulation is used to force landlords to subsidize tenants, investors endeavor to avoid this indirect tax by investing in opportunities other than rental housing. The consequence is a shortage of rental housing and the various related side effects such as reduced maintenance and illicit charges such as key money.

It is the opinion of the Inquiry that rents should not be held below the fair market level by rent regulation since the consequences are too damaging to make such a policy acceptable. Budgetary programs are superior both because they avoid the harmful consequences of restrictive rent regulation and because they provide greater assistance to the households which require it. Budgetary programs can be used to provide suitable accommodation at rents low-income households can afford, that is to say within the range of their socially fair rent. They also can be used to provide those households with additional income to enable them to pay market rent for such accommodation. In Ontario the emphasis has been on policies which provide rental housing at a cost the tenant can afford to pay.[10] These alternative approaches are discussed in the following section.

4.1.2.2 Alternatives to Rent Regulation

Unless assistance is provided to low-income households with an affordability problem, they will be inadequately housed, go short on other needs, or both. There are only two possible solutions to the problem: reduce the cost to them of purchasing the necessities of life or increase the resources they have to buy them. In the context of housing policies, that means reducing the cost of housing or giving them money to help pay for their housing. Combinations of the two approaches also are possible.

As discussed earlier rent regulation can be used to reduce the cost of housing without causing unacceptable consequences only in cases where rents are above the fair market rent level. That is, rent regulation systems must be moderate if they are to avoid negative consequences. It is clear from the foregoing discussion that moderate rent regulation does not address the affordability problem of low-income households. However, other policies can reduce the cost of housing for low-income households without causing problems for the unsubsidized private market. One approach is socially assisted housing.

10. Under the rent supplement program, the deficiency between what the tenant can pay and the landlord is entitled to charge is paid out of public funds to the landlord. As such it has aspects of both supply and and demand augmenting programs. Ontario has never had a policy of paying supplemental rent payments directly to tenants.

Socially assisted housing was discussed under the general heading of market replacing programs in Chapter 3. Although it can take a variety of forms such as public, integrated and co-operative housing, all forms have the common feature that government pays some form of subsidy to the landlord, which may be a public agency or a co-operative or non-profit organization, to cover a portion of the total cost of constructing, financing and operating the building. The subsidy, or subsidies, make it possible to charge tenants something less than the economic rent for the unit they occupy. Some of the subsidy may be paid specifically to reduce the rent paid by qualifying low-income households on a rent-geared-to-income basis. Normally, it also enables other tenants to pay rents that are below economic costs, usually established using the low end of market criterion. Because rents are subsidized, demand normally exceeds supply; hence, some system for selecting tenants is generally required, both for rent-geared to income tenants and others. Assuming that the actual rents paid by the tenants reflect society's views regarding what is a socially fair rent for them, it can be said that their affordability problems are resolved.

The alternative to reducing the cost of housing for tenant households requiring assistance is to give them additional money so that market rents will be more affordable. That type of program was discussed in Chapter 3 under the heading of demand augmenting policies. The principal example is a rental allowance program.[11]

There are advantages and disadvantages to each approach to relieving the affordability problem of low-income households. However, the Inquiry is of the opinion that, on balance, the level of assistance could be significantly improved if shelter allowances were used to complement the assistance provided by socially assisted housing and other existing programs.

Perhaps the most important limitation of socially assisted housing is that the number of households which can be assisted is limited by the number of socially assisted units available. Furthermore, even if there were enough units for all households requiring assistance it would be unlikely that the units would be in the right location, the right size, and so on, to match the needs of those households requiring assistance. Needs change over the years and the stock of socially assisted housing is neither mobile nor flexible enough to meet changing needs. Those who get a unit may have their housing affordability problem relieved, but those on waiting lists or who need to live in a location where socially assisted housing has not been built, will receive no benefit. Clearly, that is not equitable treatment among those households qualifying for assistance.

Furthermore, socially assisted housing is unlikely to be available to more than a fraction of the households qualifying for assistance in the foreseeable

11. Or a shelter or housing allowance program which would be more equitable because low-income households would qualify for assistance whether they own or rent their housing.

future. The costs associated with socially assisted housing are high and no level of government has the funds to meet fully the demand for assisted housing. A further consideration which is voiced frequently with regard to government-managed operations is that they are inefficient and expensive both to build and to operate.[12] Whatever weight should be given to this opinion, it is clear that assisting low-income households primarily through publicly-financed housing would be a massive and expensive undertaking. A further disadvantage of socially assisted housing is that when the accommodation does become available, it will require tenants to move which is contrary to the concerns about security of tenure.[13]

The foregoing disadvantages are avoided by housing allowance programs. All households requiring assistance would be given immediate help to pay their rent. There is no need to wait for one of a limited number of subsidized units to come available or for new units to be built, as is the case with socially assisted housing. Nor is there a need to move in order to receive assistance.

There appear to be two primary reasons why some critics prefer socially assisted housing. The concerns relate to the ways tenants and landlords might respond to the subsidy.

From the point of view of the tenants' response, there is concern that some tenants will not use the housing allowance to improve their housing. Given the discussion above of the inseparability of the housing affordability problem from the general income problem, that reservation clearly is misguided. The assisted households have more funds to spend on housing if that is their area of most need. But if they have been renting an adequate unit and suffering from having too little money left over for other necessities, then they should not be expected to respond to the introduction of a rental allowance by spending more on rent.

Perhaps the real concern is that some households may spend more on items which are not seen by society as necessities and socially assisted housing may be seen as a means of ensuring that public funds are spent specifically on housing. As appealing as that argument may be, it actually has little validity. A household may receive a cash subsidy of $200 per month, leaving it with an extra $200 after paying rent to spend on necessities or anything else. Alternatively, it may be allowed into a socially assisted rental unit thereby saving $200 a month on rent leaving it with $200 more than it would otherwise have to spend on necessities or anything else. The effects of the two approaches are much the same.[14]

12. See the discussion in Chant (1986, pp. 337-342) and Muller (1986, pp. 93-98, 279-280).

13. Insecurity of tenure is discussed in section 4.5.

14. Special circumstances can be scripted which support the objection to shelter allowances. For

The other objection commonly raised to rental allowances relates to the response of landlords. Many people appear to believe that if tenants receive a rental allowance, their landlords would raise their rent more than they otherwise would have. If this were the case, the tenants would end up with neither improved accommodation nor more money left over for other necessities. As discussed in Chapter 3, that situation is unlikely to occur in an unregulated market with a normal vacancy rate, because the tenants would be able to move if the landlord attempted to charge an excessive rent. Furthermore, in a regulated market, even with a moderate system of rent regulation, the landlord would not have the opportunity to charge an excessive rent.

It appears to the Inquiry that the major obstacles to implementing a rental allowance program are its cost and the difficulty of determining what is an adequate level of assistance. In large part, the latter difficulty arises because of the inseparability of the housing affordability problem from the income problem of low-income households. Shelter allowances cannot provide a complete answer to the affordability problem since, as already noted, the housing affordability problem of low-income households is only one feature of a larger income problem.

Nevertheless, even a modest shelter allowance in an amount determined by rental housing criteria would be of some benefit to a low-income household which could not gain access to socially assisted housing. The policy of paying such allowances should not be rejected because it is an inadequate response to the overall income problem of such households. That this is the case in many instances should be recognized as a reason for coordinating the social assistance programs into a genuine income policy.

Other budgetary programs which augment the supply of rental housing can serve the objective of providing relief to low-income households from the affordability problem but in a less direct way. Those programs are particularly appropriate when the affordability problem of low-income households is aggravated by a shortage in supply of modestly-priced rental units. For example, commencing in the mid-1970s, the Ontario government participated in a number of programs such as the Community Integrated Housing Program under which builders were given financial assistance on condition they made a definite proportion of the new units available to tenants receiving rent supplements. Those tenants paid rent on a rent-geared-to-income basis. Under the Private Assisted Rental Program started in 1976 and still in operation, private builders

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example, a family may live in squalid housing. If a shelter allowance is received, they may spend it in ways society considers inappropriate and remain in the inadequate accommodation. Socially assisted housing would at least ensure that their housing is upgraded if they are to receive any benefit from the program. The Inquiry is not convinced that such circumstances are prevalent enough to be the determinant of this housing policy. Other factors, such as cost and the capacity of the system are more important.

finance, construct, own and manage rental projects which have up to 100 per cent of their units available to assisted tenants on a rent supplement basis. Operating costs are shared by the federal and provincial governments.

The most recent program of this nature is the Ontario Renterprise Program announced in December 1985. Assistance to builders is in the form of interest free loans and those who take advantage of the opportunity are required to offer up to 40 per cent of their units to tenants who would pay rents based on income rather than market rents. The units must remain as rental accommodation for at least 15 years.

4.1.2.3 Affordability Conclusions

The primary difficulty in resolving the affordability problem is the level of the resource commitment needed. If the income problem of low-income households was not so severe, it would be politically realistic to expect income programs to be introduced which would remove any concern about housing affordability problems. The only concern with the price of rental housing would then be that it not exceed the fair market rent level. In the absence of a comprehensive incomes policy, there should continue to be housing programs intended to help low-income households. Four primary conclusions emerge from the discussion:

1. relieving the affordability problem of low income households is an important objective of housing programs because no comprehensive incomes policies are likely to be introduced;

2. rent regulation is not an appropriate means of alleviating affordability problems because the negative consequences of restrictive regulation outweigh the benefits realized by low-income households;

3. budgetary programs can do much to ease the affordability problems of low-income households; and

4. a package of budgetary programs is the best means of easing affordability problems, with socially assisted housing serving some segment of low-income renters, private-sector supply programs providing rent assisted units serving others, and a rental or housing allowance program providing a safety net for low-income households who cannot be accommodated by either socially assisted housing or rental allowance programs.

4.2 Excessive Rent Charges

In the affordability section above, it was observed that several distinct problems often are encompassed by the concerns expressed about the difficulty tenants

have affording their rents. One of those related problems is the problem of excessive rent charges. It is distinct from affordability problems because, unlike the latter, excessive rent charges are a characteristic of the rents being charged rather than of the households paying them. As a consequence, the resolution of the problem involves changing the rent which is charged rather than assisting the affected households financially.

A rent can only be considered excessive in relation to a rent seen to be reasonable. The Inquiry uses the concept of fair market rent which was defined in Chapter 2 as the reference point for the rent charge that is fair for a unit. It was stated in that Chapter that a criterion of fair rent is that the rent a household pays for its accommodation corresponds to the rent for similar units. If a landlord charges a rent which is unusually high relative to the rent for similar units, it can be taken as evidence of an abuse.[15] The excessive rent charge may reflect either a gouging increase or an attempted economic eviction.[16]

4.2.1 Gouging

Gouging is a term which was used freely in the 1975 provincial campaign for restraint on the rent increases demanded by landlords. In general, the imposition of any rent increase which tenants regarded as excessive came to be referred to by them as ''gouging''. The pejorative nature of the word[17] implies that gouging is reprehensible and immoral. However the term has been used rhetorically to label any large rent increase. Stanbury (1985) identifies five concepts of gouging. In this Report, the first concept is used.[18] In Stanbury's words:

15. The other aspect of fair market rent, that the industry return on investment is not excessive, is not a factor considered in this section of the Report. It is considered to be a different problem when the actual rent level is above the fair market rent level. See sections 5.3 and 5.4 for discussions of problems related to the general rent level.

16. Concerns about gouging and economic eviction were raised frequently during the course of the Inquiry's hearings. For example, M. Galway and J. Bassel discuss the use of rent controls as an anti-gouging mechanism, (Transcript 97-2, pp. 152-153). See also the testimony of M. Hogan, Transcripts 1, pp. 21-22 and 2, pp. 241 and 245-247; J. Miron, Transcript 68, pp. 65-67; D. Hunt, Transcripts 71, pp. 80-82 and 73, pp. 97-101.

17. The dictionary meaning of gouge is to swindle or extort. Those activities have a criminal connotation and there are legal definitions and precedents which serve as guides to their meaning. When gouging by landlords is spoken of however, something short of criminal behaviour of that kind is indicated. Still, with the introduction of rent regulation, a rent increase in excess of the prescribed limit could have an illegal aspect.

18. Stanbury's other four concepts of gouging are addressed under the headings of market fluctuations (section 3.5) and excess profits (section 3.7).

> "Gouging" may be defined as setting a monthly rent *above* the prevailing market rent for comparable units. (pp. 2-6)

Chant (1986) expands on that definition. He states that in a stable environment concern about gouging focuses on:

> . . . any landlord setting rents above the prevailing market rates to take advantage of ignorance on the part of tenants or some source of tenant immobility. (p. 151)

Tenant immobility becomes a factor if, in economists' terms, the tenant's transaction costs[19] of moving outweigh the cost of paying the increased rent. With regard to this concern, Chant (1986) states that questions need to be asked:

> . . . about the prevalence of rent gouging and about the ability of tenants to escape its consequences. Normally market pressures could be expected to limit the possibilities of rent gouging. Nevertheless, certain groups, in particular the elderly, may be poorly informed or may have to bear substantial economic and psychic costs in moving. These groups may be prone to facing what the public would view as unconscionable rents. This possibility should not be confused with reality. (p. 151)

In normal circumstances, most tenants would not be subject to gouging since they have a fairly good idea of what other tenants are paying and are able to move, if necessary.[20] Nevertheless, it is clear that some people, particularly the elderly and handicapped may be vulnerable to abuse and have the misfortune of having to deal with an unscrupulous landlord who charges a truly excessive rent. Although it is unlikely this form of rent charge occurs frequently, there are no data which indicate how common it is in an unregulated rental housing market for landlords to charge rents above the prevailing market rent. The Inquiry considers the practice to be sufficiently objectionable to justify remedial action being taken when it does occur.

It should be noted that the agitation for rent regulation in 1975 had to do in large measure with unusually large rent increases rather than what in this Report are described as excessive rent charges. Although in normal circum-

19. See Stanbury (1985), pp. 4-21 to 4-26 for a discussion of transaction costs.

20. Approximately one-third of tenant households change accommodation annually. See the discussion on mobility rates in Stanbury and Vertinsky, 1986, pp. 6-120 to 6-137.

stances the appearance of the former would result in the latter, that would not necessarily be so in all cases. An increase regarded by tenants as excessive might have been added to a rent that, due to prior circumstances, was well below the fair market rent for the unit. The resulting rent could still not be excessive in relation to the fair market rent for the unit. In another case, however, a similar increase could have been literally a "gouge" by which the landlord was taking advantage of the tenant's circumstances to raise the rent above the fair market rent for the unit. Adequate information is not available on the reasons for large rent increases. It is reasonable to assume that some portion of such increases was necessary to catch up to the fair market rent level. Even under rent review the Residential Tenancy Commission has granted large increases.[21] Because those increases were in accordance with the statute and guidelines and hence were "legal," it could be argued they were not excessive despite their size.

4.2.2 Economic Eviction[22]

The primary reason that gouging, as defined above, is not a widespread problem is that most tenants would move out if their landlord attempted to charge more than the going rent for similar units available in the rental market. In general, the risk of losing an on-going tenant keeps landlords from attempting to raise rents excessively.[23]

In some circumstances, however, landlords may seek to charge an excessive rent in a market where rents are not regulated. They may do so inadvertently or intentionally. In either case, it is likely that if the tenant moves out, the landlord will have to reduce the rent for the unit or allow it to remain vacant. No one is likely to move in if similar units are available at less cost.

If the intent of the landlord charging the excessive rent was to force the tenant to vacate, the practice can be characterized as a means of circumventing the security of tenure provisions of the Landlord and Tenant Act. Consequently, when that occurs, it is commonly referred to as economic eviction.[24]

Stanbury (1985, No. 15) identifies three circumstances in which economic eviction may occur which cover a broader definition than is used in this Report:

21. See the discussion of large rent increases granted by the Residential Tenancy Commission in section 1.3.

22. In research studies for the Inquiry, economic eviction is discussed in Makuch and Weinrib (1985, pp. 9-11 and 18-20), Stanbury (1985, No. 15, pp. 3-3 to p. 3-8) and Steele and Miron (1984, pp. 13-14).

23. See Steele and Miron (1984, p. 45) and Stanbury (1985, No. 15, pp. 4-24 to 4-26).

24. For example, Steele and Miron (1984) define economic eviction as:
    . . . a move caused by unconscionably large rent increases. (p. 13)

(i) The landlord raises the rent of all tenants by the same percentage across the board. He does so in response to excess demand conditions. His purpose is to increase his total revenues, but he is assumed to be indifferent whether the existing tenants stay or go as he can replace them easily. The landlord is not trying to get rid of anyone, just increasing his net income. The rents are being raised to the new, higher market-clearing level.

(ii) The landlord intends to evict *all* tenants by raising rents very sharply. His object is to obtain a vacant building so he can undertake major renovations or tear it down and build a new building which may or may not provide rental accommodation. Again, his objective is assumed to be wealth maximization. The landlord uses this method of eviction because it is less costly than obtaining an eviction order.

(iii) The landlord intends to evict a *particular* tenant by sharply increasing his rent. The motivation for the landlord to do this may be, for example, that the tenant is noisy, had done damage, or has abused the landlord personally. The landlord resorts to economic eviction because it is ''easier'' than other forms of legal redress. The discriminatory action could also violate human rights legislation if it is based on the tenant's sex, religion, colour, or ethnic background. (pp. 3-3 to 3-4)

In this Report, the first circumstance is not considered to be economic eviction. It is treated as the separate problem of rapid increases in rents due to market conditions which is discussed in section 4.4. The latter two circumstances constitute economic eviction as that term is used in this Report.

From a market efficiency perspective, economic eviction would not be a concern provided alternative accommodation is available for tenants who vacate in order to avoid an excessive rent charge. However, Makuch and Weinrib (1985) identify a ''psychological'' rationale for preventing economic eviction:

> Many tenants become attached to their home, even if it is rented from someone else and do not want to move into economically equivalent housing even if it is provided. (pp. 10-11)

It is the opinion of the Inquiry that the psychological factors associated with any forced move justify protection of tenants from situations where they

are forced to move by an excessive rent charge.[25] However, when tenants find it necessary to move because they are unwilling or unable to pay the rent being charged for a unit, it would not be fair and equitable to protect the tenant by forcing the landlord to accept a rent below the fair market rent. Those tenants who are unable to afford the fair market rent for their units suffer from an affordability problem, not economic eviction. As discussed above, the only practical solution to the affordability problem of low-income households is to provide them with assistance of some form.

4.2.3 Policies to Prevent Excessive Rent Charges

As a policy matter, it is not necessary to differentiate between economic eviction and gouging since the only difference is in the landlord's mind. If the landlord is trying to get rid of the tenant it is economic eviction. If the landlord expects to collect the higher rent it is gouging. The important factor in either case is that a rent is being charged which is excessive relative to the rent for similar units.

Both gouging and economic eviction normally can be identified by comparing the rent being charged to the rents for similar units available in the marketplace.[26] In a building containing a number of similar units tenants who believe the landlord is attempting to gouge or economically evict them generally would be able to demonstrate that situation by showing that the rents they were being charged were significantly higher than the rents paid by others in similar units in the building. If all the tenants in the building believed they were being charged excessive rents, that could be shown by comparing their rents with the rents in other buildings with comparable units. In small buildings, the tenants' rents could be compared with those in other buildings to determine whether their rents were excessive. A further test of excessive rents could be that prospective tenants would be unwilling to pay the rent demanded of the incumbent tenants.

It is difficult to conceive of an effective method of protecting tenants from excessive rent charges which does not involve a comparison of the rents of

25. The Inquiry was not presented with information on alleged cases of economic eviction which could be examined to determine their characteristics. The limited evidence heard by the Inquiry on this topic indicated that although economic evictions rarely occur it is generally accepted by both landlords and tenants that it is appropriate for government to take action to stop even those rare occurrences.

26. It should be noted that if vacancy rates are low and tenants' mobility is restricted, landlords may be able to raise the rent generally without tenants being able to move. However, those increases reflect an escalation of the market rent, not gouging as defined here. See section 4.2.1.

those tenants who believe their rents are excessive with the rents being charged generally in the market.

Specifically, it is evident that although some degree of security of tenure is provided by the Landlord and Tenant Act, that Act alone is impotent to deal with economic eviction. Steele and Miron (1984) observe that:

> . . . only the rent review provisions — not the eviction provisions [of the Landlord and Tenant Act] — prevent economic eviction, and thus households in premises exempt from rent review are not protected. (p. 13)

Budgetary policies also are ineffective in providing protection to tenants against excessive rent increases. Both gouging and economic eviction are abusive actions which are anomalies in the marketplace. No budgetary policy is likely to stop an unscrupulous landlord from attempting to take advantage of an immobile tenant. Nor would any budgetary policy be likely to discourage economic eviction if a landlord wanted to force a tenant out of the building. Direct intervention to review the rent being charged when there is a complaint is the only realistic solution.

However, not all types of rent regulation provide effective protection. Specifically, since the current system of rent regulation in Ontario fails to ensure that the rents landlords are allowed to charge do not exceed fair market rents, it cannot be relied on to protect tenants from excessive rent charges — the problem being that the previous rent may have been above the fair market rent. The review mechanism also is faulty as a protection against excessive rent charges because landlords can pass-through their costs to tenants even though those costs are excessive relative to the costs of landlords offering similar accommodation. As was argued in Chapter 2, the fair market rent for a unit depends on the normal costs of providing units of that type, not the individual landlord's costs. Furthermore, as discussed in Chapter 3, cost pass-through systems of rent regulation cannot determine fair market rent because they implicitly assume that the initial rents correctly reflected the landlords' costs and therefore a pass-through which reflects the change in the landlords cost should result in a fair rent. That is often not the case. For both those reasons, cost pass-through systems provide only limited protection to tenants against excessive rent charges.

The only effective way to protect tenants against excessive rent charges is by means of a rent regulation system which explicitly determines the fair market rents for units being reviewed. This would be done under the FMR system of regulation proposed in Chapter 5.

4.3 Excess Profits in the Rental Housing Industry

It is implicit in the arguments put forward by many advocates of tenants' interests that in the absence of rent regulation landlords would earn excess profits.[27] On the other hand, most landlords argue that the industry does not earn excess profits. That difference in views is a major cause of the conflicting positions taken by tenant advocates and landlord advocates. If tenant advocates are correct then in the absence of rent regulation tenants would be paying rents that are above the fair market rents for their units. Consequently, a system of rent regulation which holds rents down would not be unfair to either landlords or tenants and could be imposed without adverse consequences in the market, provided it did not hold rents below the fair market level. On the other hand, if landlords are correct, then any regulatory system which reduces the general rent level would be inequitable in terms of the fair market rent criterion and would reduce private sector supply.

In order to determine whether or not there is a problem of excess profits, it is necessary first to have a clear understanding of what constitutes excess profits. That is the topic of section 4.3.1. Section 4.3.2 examines circumstances which theoretically may give rise to excess profits. In addition to understanding the problem conceptually, it is important to quantify the amount of excess profits, if any, which arise in the absence of regulation in order to determine the magnitude of the rent reduction which can be justified. Section 4.3.3 reviews the limited empirical evidence which bears on the question of the magnitude of excess profits earned by investors in rental housing in both regulated and unregulated markets.

The final section, 4.3.4, turns to the question of the policies which would serve to limit excess profits without depressing rents below the fair market level and thereby bringing about the negative consequences of restrictive rent regulation identified in earlier chapters.

4.3.1 Identifying Excess Profits

In general usage, the term excess profits may refer to several concerns which are identified as distinct problems in this Report. Used in its broadest sense, the term sometimes refers to any profit the commentator considers large. A more objective criterion for identifying excess profits is needed for purposes of policy developments. In this Report, the concepts of fair return and fair

27. Representative of this view are articles in J. Gilderbloom and Friends (1981, Sections II and III). Reference is made to collusion (p. viii) among landlords and to landlords determining rent levels (p. ix). See the testimony of D. Leitch and J. Kuyek, Transcript 41, pp. 30-31, for example, and Briefs 7 and 83. It should be noted that some arguments which do not refer to the profits earned by landlords amount to the same thing as is described below.

market rent which were introduced in Chapter 2 are used to determine whether excess profits are earned. Based on that approach, it can be said that investors in the rental housing industry earn excess profits if the industry in general earns an actual rate of return on equity which exceeds the competitive, that is to say the fair, rate of return in the long run.

Certain other circumstances in which landlords may earn above-normal returns are treated in this Report as separate problems. Specifically, instances where landlords manage to make high profits by charging more than the going market rents are labelled as cases of excessive rent charges rather than excess profits. Drawing that distinction is important because the excess profits problem is a market-wide problem requiring a market-wide response, whereas the excessive rent charge problem relates only to certain landlords, making a market-wide response inappropriate.

A distinction also is drawn between the problems of excess profits and the case where abnormally high returns are earned on rental housing investment due to temporary tight market conditions. The former problem is an on-going problem requiring an on-going solution, whereas the latter problem occurs only intermittently and on a local basis; hence, the response should be to restrain rents only during those periods when profits are out-of-line. That is the topic of section 4.4 below.

It is important to note that an individual case where a landlord earns more than the competitive rate of return on investment in rental housing is not indicative of a problem in the market. That observation follows from the discussion of fair market rent in Chapter 2. That discussion showed that the fairness of returns cannot be determined on an individual building basis or on a short-run basis. It follows that excess profits can only be identified by comparing the actual long run industry return to the competitive rate of return for industry investment. As a consequence, if a landlord earns high returns because of low operating or financing costs, while rents are in line with those for similar units, those rents are not inequitable and the landlord's profit is not excessive.[28] The test of fairness is that rents for similar units are similar and that the going market rent level is adequate for landlords on average to earn the competitive return.

Further, even when the long-run return is competitive, circumstances may dictate that the annual or short-run returns will be sometimes more and sometimes less than the long run average return. Since actual returns vary from year to year and from landlord to landlord, the competitive rate of return is viewed as the allowed average return not the allowed maximum return. It may be desirable to smooth year-to-year fluctuations in rents and returns, as dis-

28. Likewise, when the landlord's returns are lower than his competitors' due to higher costs, he cannot be said to be earning too little.

cussed in section 4.4 below. However, it must be accepted that in practice, rents will be above the fair market rent level in some years and below it in others. As long as the actual return approximates the competitive rate of return in the long run, such fluctuations are not indicative of the industry earning excess profits.

Given that approach, it is clear that much of the evidence of purported excess and inadequate profits has little bearing on whether rents are fair. For example, individual cases of wealthy landlords are cited as evidence that profits are too high. No consideration is given to whether those landlords are simply earning a fair return on a large investment, or whether their financial success was the result of a large, highly levered investment on which a quite reasonable return on capital was earned. Furthermore, those who have an interest in showing that landlords earn excess profits cite examples of the most successful, rather than examining the financial performance of the industry as a whole. Individual cases do not show whether industry returns are excessive.

Conversely, landlords who lament that the industry earns too little cite examples of landlords with the lowest returns, also without considering whether the industry return is fair on average. In any competitive market, some producers do poorly. Unless their lack of success stems from unequal regulatory treatment, assistance is not called for. Rather they will have to suffer low returns or sell out to someone who has the capacity to manage their buildings more profitably.

4.3.2 Circumstances Where Excess Profits May Occur

Economic theory argues that in competitive markets excess profits cannot be realized except on a temporary basis. In the context of rental housing, theory suggests that if landlords earn excess profits new investors will enter the industry, vacancy rates will rise and rent increases will be slowed. That process will continue until there are no excess profits to attract a high level of investment into the industry. Going a step further, it is clear that developers will commence projects when they foresee the opportunity to make a normal or above-normal profit. Given this sequence of events excess profits are likely to be realized only if rental housing developers fail to fully anticipate the growth in demand which ultimately occurs.

Most economists who have addressed the question of whether the theory of competition is relevant to the rental housing market agree that in general it is.[29] There are too many different companies and individuals with the financial

29. For example, see Chant (1986), Clayton (1984), Fallis (1984), Muller (1986), Stanbury (1985, No. 15), Stanbury and Vertinsky (1986). Also see references in Adams, Ing and Pringle (1986, I).

resources and expertise to develop rental housing for a credible argument to be made that they collaborate to keep rental housing in short supply and hence rents and returns at excessively high levels. If there are excess profits in the rental housing industry, they must result from some characteristic in the industry which causes shortages to be an on-going feature of the industry despite the fact that the opportunity to earn exceptional profits provides a strong incentive for developers to increase the rate of new construction.

This section examines the principal arguments which are used to support the view that competition fails to eliminate excess profits in the rental housing industry. The first, discussed in section 4.3.2.1, attributes the problem to the limited supply of land. The second, which is discussed in section 4.3.2.2, attributes the problem to the fact that given current housing standards, no new supply of low rent buildings can be built; hence, there is an on-going supply shortage of low-rent buildings.

4.3.2.1 Excess Profits Where No Developable Land is Available

It is sometimes argued that landlords whose properties have increased in value due to the development and growth of the areas in which their properties are located, enjoy unearned and hence excess profits.[30] As the location becomes more attractive, rents can be raised making the investment more profitable and at the same time the site becomes more valuable.

The reason this could occur is that while an increasing number of households may wish to live in the desirable location, once all land available for development has been used up, the increased demand cannot be accommodated. The scarce units then are rationed out on the basis of who is willing and able to pay the most. Furthermore, if there are zoning or other restrictions which inhibit intensification of the use of the land, the shortage of housing in that location cannot be alleviated by redevelopment. The consequence is clear to all — the location has increased in value. The property commands higher prices and rental units command higher rents. The differences of opinion arise over who should capture those benefits.

While it is unquestionably true that there may be a limited supply of land in any particular location, it does not follow that owners of real estate inevitably make excess profits. Anticipated increase in the attractiveness of a location for rental housing is a factor investors take into consideration. The possibility of that increase in attractiveness will be reflected in the price they pay for the property. If the attractiveness of the location increases more than was antici-

30. The business of landlording itself as distinguished from investing in the land on which the buildings sit is too open to new entry and sustained competition to be a credible source of excess profits. See Appendix D for a discussion of competition in the residential rental industry.

pated, the owner will enjoy a high return on his investment which some critics describe as being unearned, speculative or excess profit. Accordingly it is argued that the rents should be held down to be commensurate with some lesser value of the land, presumably one more in keeping with what the market expected when the property was acquired — as reflected in its value at the time the landlord purchased the property. The counter argument is that the so-called unearned profit provides a legitimate return on the investment because when the investment was made the investor accepted the risk that the increase in value of the property would be less than was anticipated, and his consequent return would have been substandard.

The Inquiry accepts the counter argument. However, that acceptance is not based on a value judgement that landlords are more deserving of the benefits of increased land value than tenants. It is based on purely pragmatic considerations. First, investors must receive a return on their investment in some way. One of the attractions of real estate investment is the expectation that the property values will increase. The evidence on historical rates of return in the industry indicate that the expected value increases are taken into account when people invest in real estate, making them willing to invest despite lower current rent levels than they would otherwise accept. The consequence of removing the expectation of future increases in rental property values would be to increase the current rent level which would be required to attract new investment. In other words, to the extent that the private market meets the demand for rental housing in Ontario, tenants and policymakers have a clear choice: allow landlords to capture the benefits of increased property values, or accept less development of new rental properties, lower vacancy rates and higher rents for new buildings.[31]

The consequences of denying landlords the benefits of increases in land value are made particularly severe by the fact that they inevitably bear the costs associated with the risk that the rents their properties will command in the future will turn out to be less than expected. To illustrate that point it is helpful to consider the effects a regulatory system which denies landlords the opportunity to capitalize on the increased attractiveness of the location of their property. The primary effect is to transfer those benefits to tenants. Where such a system is in place, tenants are able to continue to occupy the unit, benefitting directly from the more attractive unit. They may also be able to benefit financially from their tenure rights. That can be done by "selling" their tenure rights,[32] for example, by charging the next tenant key money.

31. Also see the discussion of these issues in the section on rate base-rate of return in section 3.1.3.2.

32. See the study by Mascall (1985, pp. 99-107 and 109-110) and his evidence in Transcripts

However, while regulatory systems can transfer the benefits to tenants, it cannot make the tenant accept the downside risk associated with locations which do not increase in value as expected. If rents are raised to cover increasing costs or even are left at their original level but are thought by the tenants to be more than the accommodation is worth, the tenants are free to vacate at their pleasure. Is is not equitable to design a regulatory system which transfers the benefits of increasing locational attractiveness to tenants while leaving the costs of decreasing locational attractiveness to landlords. For equitable treatment, it is necessary that both the benefits and costs reside with the same person, that is to say the landlord, just as homeowners both gain from increased value of their property and lose from decreases in value.

Furthermore, if the value of some locations increases less than anticipated, some landlords will have unanticipated losses, based on the purchase price of the land and the competitive return on the investment made in purchasing or developing the property. Just because some locations are increasing rapidly in value, it cannot be concluded that the industry as a whole is earning excess profits.[33] If excess profits are derived from gains on underlying land values, then to argue that the rental housing industry consistently makes excess profits would imply that there is a general trend of unanticipated increases in property values due to changes in locational attractiveness. It is unlikely however that increases in land value would be underanticipated for any great length of time. Investors would realize eventually that there was a market opportunity and new investment would counter any tendency to excess profits.

Even if it could be shown that the industry earns excess profits due to increased land values, attempts to deny owners of rental property the benefit of such gains would be counterproductive unless that benefit was also denied owners of property used for other purposes. The benefit of increased land values accrues to all property owners, not just those who hold rental property. If that benefit is denied to those who use their land as sites for rental accommodation, the effect will be to encourage owners to put their land to other uses. Hence, any action to limit the enjoyment of those gains by landlords would simply lead to shortages of rental accommodation. The only fair policy for limiting profit due to the increasing locational attractiveness of land would be generalized taxes or other measures designed to limit speculative gains on all land holdings. Recommendations on that issue are not related to the question of rent regulation and are beyond the terms of reference of this Inquiry.

127, pp. 140-147 and 128, pp. 138-140. See, also, the discussion and sources cited in Stanbury and Vertinsky (1986, pp. 2-23, 4-32 to 33 and 4-52 to 57).

33. It should not be possible to make excess profits in the long-run unless the increases in land value are consistently underanticipated. No explanation of why this might occur has been presented to the Inquiry.

4.3.2.2 Excess Profits on Low Rent Housing

In the private market, low-rent accommodation tends to be in older buildings. New buildings tend to be at the higher end of the rent scale. That is the inevitable result of the increasing cost of new construction and the declining attractiveness of aging buildings.

The supply of inexpensive unsubsidized housing cannot be increased since buildings with low rents cannot be built today.[34] The supply of inexpensive rental housing, however, will decline as older rental buildings are demolished, renovated and converted. As the years pass, all buildings age and those which were once high-priced become cheaper relative to more recently constructed units. This process is referred to as filtering down of the housing stock. But the filtering process may not occur rapidly enough to meet the growing requirement for low-priced rental housing based on the rents tenant households can afford to pay.

As an urban area grows there is a need for additional housing at all price levels. While the market can respond to the need for high-priced housing, it cannot respond to the increased need for low-priced housing if demand grows more rapidly than the filtering process can augment the supply of low-rent housing. If low-rent housing is in short supply, the imbalance between supply and demand would be eliminated by increasing the price until demand falls but that would not lead to an increase in the number of low-priced units. If rents are not controlled, the immediate result would be an increase in the rent payments of tenants and the rental income of landlords. In markets where the supply of low-priced rental units cannot keep up with growing demand, government intervention can relieve the imbalance by increasing the supply of units renting below the economic rent for unsubsidized private supply, rather than by simply letting rents rise to force households out of the market. Appropriate policy responses are discussed in section 4.3.4 below.

4.3.3 Evidence of Excess Profits

It appears that many people believe landlords, unless restrained by rent regulation, make too much money. The Inquiry interprets this to mean that they perceive landlords to be earning excess profits, that is, their return on investment is consistently above the competitive rate of return. Whether that perception is valid is of critical importance to the question of how rents should be regulated. If excess profits are earned in the absence of regulation, it can

34. A limited supply of market housing at low rents may be made available through conversion from ownership to rental.

be argued that regulation should be used to hold rents down.[35] That could be done without compromising the adequacy of supply. However, if the industry does not earn excess profits, a regulatory system which holds rents down will inevitably lead to a shortage of investment, inadequate supply and low vacancy rates. This section addresses the question of whether or not the rental housing industry earns excess profits.

A popular way of saying that landlords make too much money is to argue that the tenants buy the building. That is said to occur because ordinarily the principal repayments on the mortgage would be paid out of rental income. It appears to tenants that their funds rather than the landlords' funds are used to pay for the property. That circumstance is considered to be evidence that landlords earn excess profits and that rent regulation is needed to hold rents down. As was shown in Chapter 3, the repayment of mortgage principal is a part of the landlords' total return. If landlords could earn a fair return without taking the repayment of principal component of the total return into account, it is evident they would be earning excess profits. In this event, there would be some justification for saying the tenants indeed buy the building; hence, rent regulation should be used to reduce rents by an amount equal to the principal of the mortgage.

However, economists point out that in competitive markets all sources of investment returns are recognized. A landlord's return should equal the sum of the cash income taken out of the business plus any increase in the value of the equity in the property resulting from paying down the mortgage. Several factors can contribute to changes in the landlord's equity, including increases or decreases in the value of the property, undistributed operating profits or losses, and principal repayments. Since the repayment of principal is a component of the change in the landlord's equity, and the change in the landlord's equity is a component of the landlord's return on investment, it is clear that the repayment of principal is one factor in the total return on investment of the landlord. If economists are right, then the mortgage principal is repaid out of the landlords legitimate return. It does not represent excess profits.

If a calculation of the landlord's return on equity were undertaken, and it was found that cumulatively over a number of years an excess return was obtained equal to, or greater than, the original cost of the building, it could be said that the tenants bought the building. That is the same thing as saying that the building was bought by the landlord out of excess profits. On the other hand, if it were found that the landlord did not earn excess profits, taking into account the increase in the value of his equity due to the repayment of principal,

35. It also should be noted that if excess profits exist, it is important to determine their magnitude. That is a prerequisite to determining how much rents can be reduced without deterring private investment to the point of creating a shortage of rental housing.

as well as all other relevant factors, it would have to be concluded that the reduction in principal and the resulting cash benefit upon the sale of the building were part of the landlord's required return.[36] That is to say, the landlord would have bought the building out of the return on equity which would have been received as cash income had the principal not been reduced.

For those reasons, the Inquiry does not consider the argument that the tenants buy the building as evidence of the existence of excess profits in the industry. For the same reasons, it is invalid to argue that landlords do not need to earn an annual income merely because the capital gain realized when the property is sold may provide an adequate return by itself.[37] Similarly, it is invalid to argue that no capital gain is needed since landlords receive an annual return. The only way to determine whether or not the rental housing industry earns excess profits is to collect financial data on the industry and compare the actual return with the calculated competitive rate of return for the industry.

A standard against which to measure an adequate return would be an investment in a prime quality bond from which the investor could expect an assured interest income of a fixed amount and, in due course, the recovery of his capital intact. The return on an investment in rental housing however, is not a certain contractual interest payment, but an uncertain residual after all other expenses have been paid. The investor must take into account the risk that all or part of the investment may be lost and the uncertainty as to the actual return which will be earned.[38] As a consequence, an expected return somewhat greater than that offered on a prime quality bond will be required to attract investment into the industry.

Comprehensive financial data on the industry are not available and it was not within the scope of the Inquiry to carry out a study of the returns earned by Ontario's 100,000 or more landlords. However, a number of studies of selected landlords over selected periods of time have been conducted. Appendix E reviews much of that evidence. As that review shows, the returns earned by the industry are highly variable; hence, with the limited data available, the

36. The cash benefit typically includes a capital gain on the value of the property. Capital gains reflect an increase in the present value of the expected earnings of the building. It is normally anticipated that new buildings will run deficits in early years, break even after three to five years and then earn higher returns on the original equity in later years. As long as this trend of increasing returns is the norm, capital gains will be part of the normal return on investment in rental housing.

37. See, for example, the testimony of J. Kuyek and D. Leitch, Transcript 41, pp. 13-15, 45-49, 101-103 and 151.

38. The risks include the possibility of further government intervention which would have a serious effect on the success of the investment. The greater this political risk, the higher the expected return must be to attract investors.

long-run profitability of the industry cannot be estimated precisely. The Inquiry has concluded that until additional financial data can be collected and analyzed it cannot be proven conclusively whether or not the industry is earning long-run excess profits due to some characteristic of the market which interferes with the normal operation of the competitive mechanism. Nevertheless, the evidence shown in Appendix E does support the conclusion that the industry's actual long-run rate of return on equity at the most cannot be more than five percentage points above the required rate of return. The amount of excess profits, if they exist, is less than five per cent of total landlords' equity.

The size of the overall rent reduction necessary to eliminate excess profits can be approximated using a few simple assumptions. The greatest possible amount of excess profit that is consistent with the studies reviewed in Appendix E is five per cent of equity. A conservative estimate would be that 35 per cent of total rental income is required to cover operating costs and at least 40 per cent of total rental income is required to pay mortgage interest for the industry on average.[39] Therefore, no more than 25 per cent of total rental revenue is available as a return on equity assuming rents to be at the fair market level. That is to say that 25 cents out of each dollar of rental income would be available to provide the required rate of return on equity. Taking Quirin's (1986, p. 224) estimate that the required rate of return for investment in rental housing in early 1985 was in the range of 17.1 to 19.5 percent of equity then for the actual return to have been five percentage points above the required return it would have been in the range of 22.1 to 24.5 per cent of equity. This would mean that rents would have been high enough to have provided about 32 cents[40] rather than 25 cents as return on equity or about seven cents more than would be provided by rents at the fair market level. Given those assumptions, it is evident that to have corrected for the largest amount of excess profit which

39. Campbell Sharp (1984) found that for their sample of landlords, operating and administrative costs accounted for between 38.3 per cent and 55.8 per cent of total revenue during the 1970-83 period. Interest costs accounted for between 31.2 per cent and 42.0 per cent of total income. Even if depreciation is eliminated on the basis that property values did not decline, the share of total rental income left over as a return on equity was between 4.7 per cent and 22.9 per cent. It can be conservatively estimated that operating costs account for at least one-third of total revenue. Appendix 3-C of Quirin (1986) provides capital structure tables for corporations in the Toronto Stock Exchange Property Managers and Developers industry groups. The mean values of the proportion of debt financing range from 65.8 to 78.4 per cent including ratios based on both the book value and the market value of the equity. Even if smaller landlords have lower debt rates on average, the proportion of debt can be conservatively estimated to be about 60 per cent.

40. The calculation is in the range $25 \times (22.1/17.1) = 32.31$ to $25 \times (24.5/19.5) = 31.41$. The mid-range figure of 32 is assumed.

could occur would have called for a rent reduction of about 6.5 per cent.[41] For rent regulation to have eliminated excess profits therefore would have required a rent reduction of $19.50 on a $300 rent and $39 on a $600 rent.[42]

If the amount of excess profit is only about one per cent of equity, which is far more likely, the justifiable rent reduction would be about 1.3 per cent of the unregulated rent. In that case the necessary reduction on a $300 rent would be about $4 and on a $600 rent about $8 per month.

4.3.4 Policies Regarding Excess Profits

The rental housing industry earns excess profits if the actual rent level exceeds the fair market rent level in the long run. It is the Inquiry's position that if the actual rent level in the industry exceeds the fair market rent level on an on-going basis this is not fair to tenants and government should take action which will result in rents being reduced to the fair market rent level. Given the limited empirical evidence which is available and credible it can only be concluded that if the industry does earn excess profits, rents have been no more than a few percentage points above the fair market rent level on average in unregulated rental housing markets. Furthermore, the data are consistent with the theoretical arguments which suggest excess profits are not sustainable.

If it could be shown that the industry earns excess profits, the most direct approach to holding rents down would be to regulate them.[43] If a system of rent regulation is to effectively eliminate the possibility of excess profits without impairing the operation of the market, it must be a moderate rather than a restrictive system of rent regulation. A comprehensive survey to determine the industry's return on investment is needed in order to estimate the gap between the actual and fair market rent levels. The survey also must determine what the fair return for the industry would be and what rent adjustment is required to bring actual rents and fair market rents into balance.

It is important to note that no one has attempted an indepth survey to produce results sufficiently informative to serve as a basis for setting fair rents

41. The calculation is (7/107) = 6.54.

42. Slack (1986) and Stanbury and Vertinsky (1986) estimated that controlled rents are held 10 per cent below the market rent level and that would have prevailed in the absence of rent regulation in Ontario. As a method of eliminating excess profits, that size of a rent reduction could only be justified if the industry were earning excess profits at the rate of about 44 per cent of equity annually.

43. The Fair Market Rent system of rent regulation described in Chapter 5 will serve to reduce rents to eliminate excess profits if they exist. However, if excess profits would not be a problem in the absence of regulation that system of regulation will have no effect on the overall rent level.

within a system of rent regulation. Without such a survey the amount by which rents should be reduced or increased is determined arbitrarily, based primarily on political rather than economic or social considerations. Regulating rents on that basis introduces the risk that rents will be depressed to a level at which the industry cannot earn the competitive rate of return.

The lack of a survey in Ontario means there has been no basis for determining whether the overall level of rents is fair and hence whether rent regulation reduces rents more or less than is needed to eliminate excess profits. Whether or not landlords were enjoying excess profits during the pre-regulation period, the decline in new investment is a reason for concluding that since that time the industry has not been making excess profits.

The matter of excess profit is complicated by the fact that the industry is not homogeneous.[44] The state of affairs for one category of landlords might not prevail in another and a regulatory policy suitable to one might not be suited to another. It is argued in section 4.3.2.2 that for units with rent levels significantly below the economic rent for even the most modestly designed and constructed private sector rental housing, a credible argument can be made that the problem of excess profits may occur. If that can be shown to be a valid concern based on the financial data of the industry, then it may be appropriate to impose a system of rent regulation which would have the effect of reducing rents only for those segments of the market where excess profits are a demonstrated problem.

The problem of excess profits can also be dealt with through policies which increase competition in the rental market. For example, supply augmenting programs would be of benefit to deal with the problem of excess profits in the low-rent segment of the rental market. They could be used to increase the supply of either publicly or privately owned housing which would be available in the lower rent ranges. Socially assisted housing, if built in sufficient quantity, tends to raise vacancy levels in private housing and thus exert a dampening affect on rent increases.[45] Stimulating private sector supply will have a similar effect.[46]

A positive contribution to increased supply and hence market competition is to relax zoning restrictions and building standards. By so doing not only might more housing be brought into the market but its arrival rate would be

44. Chapter 1 and Appendix A discuss the diversity of landlords and tenants.

45. It must be kept in mind however that socially assisted housing displaces privately financed housing which otherwise might have become available and the new socially assisted housing is not in its entirety a net addition to supply.

46. Even ownership programs could contribute to inhibiting rent increases if they attract renters into the ownership market who otherwise would be occupying low rent units.

expedited. The Inquiry recognizes that zoning and building restrictions reflect social values which are important to the community and a balance must be struck between market considerations and those values.

4.4 Rapid Increases in Rents due to Changing Market Conditions

In defining the list of problems examined in this Chapter, it was observed that the circumstances which give rise to the actual market rent level being greater than the fair market rent level are divided into two separate problems for purposes of this Report. The first is the problem of excess profits which is discussed above. The excess profits problem exists only if it is a characteristic of rental housing markets that actual rents exceed fair market rents on an ongoing basis. That problem focuses on the long-run profits in the industry. If a period of high profits when the actual rent level is above the fair market level is followed by a period when the actual rent level falls below the fair market level, it is quite possible that excess profits are not earned in the long-run.

Although the excesses and shortfalls in the rent level and industry profits may balance out in the long-run, the short-run fluctuations may be sufficiently severe to justify policies which smooth the rate of change of rents. Tenants, in particular, are concerned about the disruptions they suffer if rents escalate rapidly in response to tightening market conditions or other factors. In this Report, a rapid increase in the level of rents is treated as a problem in its own right.

It is sometimes argued that there is no need to stabilize the housing market since the price movements are self-correcting. As rents rise above the fair market rent level, the rate of new investment will increase until the supply of housing is sufficiently abundant that competition will push rents back to the fair market level. In general, this mechanism is accepted as the basic mode of the Canadian economy. However, it must be recognized that the rate of price change is of greater concern in the rental housing market than in the markets for other goods and services for a number of reasons. One reason is that rent plays a large part in tenant households' total expenditures.[47] A sharp increase in the rent can be disturbing, especially to lower income tenants, because it cannot be easily absorbed. The increase may force tenants to change their consumption patterns.

A second reason for government intervening to protect tenants against sudden, sharp rent increases is that the relationship between buyer and seller

47. Fallis (1984, pp. 39-40 and 49-53), Hulchanski (1984, p. 80), Stanbury (1985, pp. 4-28 to 4-32), Stanbury and Thain (1986; pp. 3-10 to 3-13 and chapters 5, 6 and 7).

is different in the rental housing market than it is in the markets for most other goods and services. An essential feature of free and unregulated markets is that the parties to a transaction can settle the terms of their contract by bargaining or negotiating. If the parties cannot agree then there is no contract and they walk away. Subject to laws governing such matters as the disclosure and truthfulness of information, the prices for most major consumer purchases involve some degree of negotiation. For example, when purchasing houses, cars, furniture and major appliances, consumers can easily shop around for a better price if some vendors are charging unreasonable prices. Households shopping for a new apartment unit are in a somewhat analogous situation; ongoing tenants, however are not. The mere fact that they live in a unit makes it unique for them. Furthermore, if the price of other items goes up, households not only have the option of buying a cheaper substitute but they can buy less of it or delay the purchase. When rent goes up, however, tenants have to pay the full increase or move out. Due to those factors, security of tenure is a problem unique to the rental housing market.[48]

A third reason for being concerned about the rate of price change in the rental housing market is that the housing market is slow to respond to imbalances between supply and demand which are not foreseen since planning, land assembly and construction take a long time.[49] The result is that a significant period of time may elapse before new supply is ready for occupancy and rents may be driven up more than is necessary to attract the required new investment.[50] A smaller increase during that period of time may be sufficient to perform that necessary function and will be less burdensome to tenants.

Given the importance of rent in the typical household's budget, the emotional cost of moving to a cheaper unit and the adjustment delays, it is not surprising that tenants prefer a greater degree of orderliness in the rent increases they are likely to face when market conditions change suddenly and unexpectedly.[51] The Inquiry accepts the view that it is socially desirable to smooth the rate at which rents adjust upward. However, action taken to achieve this result should not reduce landlords' long-term return on investment to less than the competitive rate of return. It must be recognized that anything done to

48. See the discussion of insecurity of tenure in section 4.5.

49. Clayton (1984) suggests that a typical large project takes at least two years from the beginning of land assembly and planning to the units being ready for occupancy. Construction alone takes more than 15 months on average.

50. To some extent supply may be quickly increased by conversion of ownership units; hence, the worst problems will occur when there is an unanticipated shortage of both rental and ownership housing.

51. In fact, if tenants are risk-averse they likely would be willing to accept higher rents on average, if the uncertainty about rent increases could be reduced.

limit rent increases under tight market conditions will have the effect of increasing the prevailing rent level at other times. This is unavoidable if the industry is to earn an adequate long-run return.

While acknowledging there are circumstances when it is justifiable to restrain the rate of rent increase, it should be observed that those circumstances are the exception, not the norm. This can be shown by considering the annual rates of rent increase over the past three decades. Table 1 shows the nominal rent index[52] and the percentage change in rents for Canada since the early 1950's. It also shows that relative to the rate of increase in all prices as measured by the Consumer Price Index (CPI), rents have declined since the late 1950s.[53] Only recently (1983 onwards) have increases in rents outpaced the rate of inflation. Throughout that period, rents have never increased rapidly relative to the rate of increase in costs and incomes generally.

The rate of rent increases is less smooth in local markets than it is on a nationwide basis, however. That is shown in Table 2 which presents rent data on a regional basis. Those data are available only since 1971. Table 2 shows for the centres on which data are available, the same trends of rising nominal rents and decreasing real rents throughout the 1970s and early 1980s; however, there is significantly more variation in the rates of increase.

Rents can rise rapidly for a variety of reasons. A rapid increase in operating costs or interest rates which would have a direct effect on landlords' financing costs could lead to escalating rent charges. In that circumstance, however, it is probable that the general rate of inflation is high and the incomes of most households also would be increasing rapidly. For most households, increasing income will mitigate the effects of increasing rents.[54]

Tenants are faced with a more disruptive situation if rents increase rapidly due to a local situation of excess demand.[55] The increase in rents will tend to attract additional rental housing investment which will eventually increase vacancy rates and slow rent increases until rents no longer exceed the fair market level. Neverthless, many tenants could be displaced by their inability to pay the rent increases demanded. The desire of tenants to be protected against such circumstances is quite understandable.

52. The rent index is claimed to have a downward bias, that is it underestimates the real increase in market rents (Muller, 1978, p. 21-22; Ontario Economic Council, 1976, p. 6). Provided the bias is fairly consistent, however, the volatility of the index is correctly represented.

53. The rent index is based on averages. Individual rent increases may show greater variability.

54. Households on fixed incomes will have difficulty even with rent increases which are in line with the general inflationary trend. This is considered to be part of the affordability problem discussed in section 4.1.

55. For example, a new industry may establish in a small community, attracting workers and increasing housing demand more quickly than supply can respond.

TABLE 1: Rent Index, Canada, 1950-1985

	CPI All Items	Rent Index		Annual Percentage Change		
				CPI All Items	Rent Index	
		Nominal	Real		Nominal	Real
1950	25.2	40.2	159.5	—	—	—
1951	27.9	42.5	152.3	10.7	5.7	−4.5
1952	28.5	44.9	157.5	2.2	5.6	3.4
1953	28.3	46.6	164.7	−0.7	3.8	4.5
1954	28.5	48.2	169.1	0.7	3.4	2.7
1955	28.5	49.5	173.7	0.0	2.7	2.7
1956	28.9	50.4	174.4	1.4	1.8	0.4
1957	29.8	51.3	172.1	3.1	1.8	−1.3
1958	30.6	52.2	170.6	2.7	1.8	−0.9
1959	31.0	52.8	170.3	1.3	1.1	−0.2
1960	31.4	53.1	169.1	1.3	0.6	−0.7
1961	31.6	53.2	168.4	0.6	0.2	−0.4
1962	32.0	53.4	166.9	1.3	0.4	−0.9
1963	32.6	53.5	164.1	1.9	0.2	−1.7
1964	33.2	53.8	162.0	1.8	0.6	−1.3
1965	34.0	54.1	159.1	2.4	0.6	−1.8
1966	35.2	55.0	156.3	3.5	1.7	−1.8
1967	36.5	56.8	155.6	3.7	3.3	−0.4
1968	38.0	59.2	155.8	4.1	4.2	0.1
1969	39.7	61.6	155.2	4.5	4.1	−0.4
1970	41.0	63.6	155.1	3.3	3.2	−0.1
1971	42.2	64.6	153.1	2.9	1.6	−1.3
1972	44.2	65.4	148.0	4.7	1.2	−3.3
1973	47.6	66.3	139.3	7.7	1.4	−5.9
1974	52.8	68.1	129.0	10.9	2.7	−7.4
1975	58.5	71.8	122.7	10.8	5.4	−4.8
1976	62.9	76.8	122.1	7.5	7.0	−0.5
1977	67.9	81.6	120.2	7.9	6.2	−1.6
1978	73.9	85.9	116.2	8.8	5.3	−3.3
1979	80.7	89.7	111.2	9.2	4.4	−4.4
1980	88.9	94.0	105.7	10.2	4.8	−4.9
1981	100.0	100.0	100.0	12.5	6.4	−5.4
1982	110.8	109.0	98.4	10.8	9.0	−1.6
1983	117.2	117.2	100.0	5.8	7.5	1.7
1984	122.3	123.1	100.7	4.4	5.0	0.7
1985	127.2	128.3	100.9	4.0	4.2	0.2
Average[1] Increase	4.7%	3.4%	−1.3%			
Standard Deviation				3.7	2.3	2.6

NOTE: 1. Effective compound annual average increase, 1950-1985.

SOURCE: Derived from Statistics Canada, Cat. 62-010, various years.

TABLE 2: Annual Percentage Change in Rent Indexes, Regional CMA'S, Ontario, 1971-1985

	CPI All Items	Ottawa Rent Index		CPI All Items	Thunder Bay Rent Index		CPI All Items	Toronto	
		Nominal	Real		Nominal	Real		Nominal	Real
1971	—	—	—	—	—	—	—	—	—
1972	4.86	1.98	−2.74	4.45	2.31	−2.04	4.94	1.36	−3.41
1973	7.95	2.69	−4.87	7.40	5.33	−1.93	7.85	1.64	−5.76
1974	10.84	3.35	−6.75	10.86	9.05	−1.63	10.60	2.64	−7.20
1975	9.59	4.09	−5.02	11.30	5.91	−4.84	10.71	6.00	−4.26
1976	7.58	5.28	−2.13	8.80	7.44	−1.25	7.30	6.06	−1.15
1977	8.14	7.21	−0.86	7.78	4.94	−2.63	7.75	5.59	−2.01
1978	8.39	5.76	−2.43	8.08	3.77	−3.99	8.52	4.93	−3.30
1979	8.95	4.99	−3.63	8.81	4.54	−3.93	9.20	4.36	−4.44
1980	9.56	3.89	−5.17	9.82	4.45	−4.88	10.16	4.40	−5.23
1981	11.86	4.06	−6.97	12.18	3.95	−7.34	12.49	5.26	−6.42
1982	9.90	6.50	−3.09	9.96	4.70	−4.78	11.30	7.40	−3.50
1983	6.73	8.26	1.43	6.07	4.78	−1.22	6.02	7.45	1.35
1984	5.03	5.90	0.83	4.87	3.74	−1.08	4.83	5.63	0.77
1985	4.14	6.06	1.84	4.40	4.22	−0.17	3.88	5.17	1.24
Standard Deviation	2.20	1.70	2.75	2.45	1.60	1.94	2.56	1.80	2.69
Average Increase (Percent)[1]									
1971 − 1975	8.29	3.03	−4.86	8.47	5.62	−2.62	8.50	2.89	−5.17
1976 − 1985	8.05	5.84	−2.05	7.97	4.34	−3.36	8.20	5.57	−2.43
1971 − 1985	8.09	4.99	−2.86	8.17	4.93	−3.00	8.22	4.83	−3.13

NOTE: Effective coumpound annual average increase, 1950-1985.

SOURCE: Derived from Statistics Canada, Cat. 62,010, various years.

Large rent increases also may occur on the level of individual buildings. For example, there could be large rent increases following a change of ownership or when a landlord seeks to "catch-up" on rents which had lagged behind the market for some time. However justified the rent increases may be, they can be disturbing to tenant households.

The difficulty in dealing with this problem is balancing the tenant concern that rents not increase at too rapid a rate, with the landlord concern that in certain circumstances higher rents, perhaps even substantially higher rents, are consistent with their earning a fair return on investment.

4.4.1 Policies for Smoothing Rent Increases

Smoothing the operation of the market is a commonly recognized objective of rent regulation. In a study prepared for the Inquiry, Fallis (1984) said:

> In part the support for rent regulation comes from our inability to deal with the turbulence and uncertainty of the last decade, when we have had high and variable rates of inflation, changes in relative prices, low growth in real income, and high unemployment. (p. 55)

Earlier in his study Fallis remarks that given the existence of controls, the system should be one that "alters the adjustment path of rents but not the long run level . . . tenants would be protected against sharp extraordinary increases but not against finally having to adjust to inflation or a long run relative price change on their unit." (p. 35)

In the same vein, Arnott (1981) states:

> . . . there are circumstances in which *temporary* controls are desirable. If, for whatever reason, rents are expected to increase rapidly over a short period and then level off or fall, using rent control to smooth the time path of rents can reduce disruption in the market. (p. 110, emphasis in original)

Arnott (1981) develops the argument for rent control as a device to reduce the costs of economic change as follows:

> . . . rapid change is costly. The housing market is volatile, and because builders sometimes underestimate the strength of demand in the market, there will be periods when rents rise very rapidly. Builders will respond to this, and eventually rents will fall back to a 'normal' level. But in the interim, many tenants will be forced to

> move. It may be less disruptive to impose rent control and smooth the price adjustment. (p. 28)

To serve this goal, it is necessary that on occasions when there are abnormal rent increases, a limit should be imposed on the amount by which rents may increase. The question then becomes how to determine what the limit should be.[56]

In the context of curbing excessive market fluctuations, the conditions for a satisfactory rent control guideline are that it should be enough to inhibit large rent increases without being so low as to stifle investment in the rental housing market. This implies that rents of individual units should be allowed to move to the fair market level in an orderly way. Landlords would be treated fairly in that rents would be at a level which enables them to earn a fair return.

Budgetary programs, particularly supply augmenting programs, could play an indirect part in stabilizing the market. Subsidies and tax expenditures can be directed to provide rental housing in areas of the market where potential shortages might lead to sharp rent increases. Conversion of domestic housing and existing structures to rental housing can bring new units into the market relatively quickly. In that regard action can be taken to reduce and simplify the approval process and other impediments to conversion of ownership to rental and intensification of land use through development. Financial assistance for conversion and renovation to provide rental units within owner-occupied houses also would be of assistance.

While it is a realistic objective of rent regulation to slow the rate of rent increase under tight market conditions, it is evident that rent regulation itself will not resolve the underlying rental housing shortage. Hence, rent regulation should only attempt to restrain rent increases while allowing market forces and complementary budgetary and institutional policies to increase supply to alleviate the tight market conditions. The problem of availability of rental housing is dealt with more thoroughly in section 4.8, below.

4.5 Insecurity of Tenure

Security of tenure has become a catch phrase[57] in discussions of residential tenancy problems. It can be translated as the right of a tenant household to

56. See the discussion in Muller (1986, pp. 193-201) Stanbury and Vertinsky (1986, pp. 4-57 to 4-59, 4-77, and 7-23 to 7-28) and the testimony of L. Smith, Transcript 36, pp. 143-144.

57. It probably was introduced into the Canadian picture by Wishart F. Spence as he then was, later Mr. Justice Spence of the Supreme Court of Canada, in "Rent Control in Canada" written by him in 1945 and quoted in the Ontario Law Reform Commission Interim Report 1968 at page 64.

continuing enjoyment of the rented premises occupied by it. It is not an absolute right and the conditions of its enjoyment are determined in part by the terms of the contract, expressed or implied with the landlord and otherwise by legislation and regulation.[58] The secure enjoyment of the right also may be lost because of the depressed economic position of the tenant.

The case for security of tenure was graphically put by Diana Hunt, an advocate for tenants' interests, in the course of the hearings. She said:

> . . . it is our position that security of tenure is absolutely fundamental as a social good, and something that tenants have to be able to rely upon within reason. We are not talking about people staying forever without paying rent, or anything like that. But some kind of reasonable security of tenure is so important that you've got to protect it as far as you can within reason.
>
> And it is really unfortunate if a tenant looks at a proposed rent increase and says, 'I just can't squeeze [that]' and moves out, thereby losing his home, his neighbourhood, any friends that are around, the services that the neighbourhood provides, the schools that his children are in the middle of attending, and whatever else. (Transcript, Volume 71, p. 80-81)

When this eloquent plea is reproduced by academics it becomes "a psychological rationale" for security of tenure which relates to "what reasonable expectations the members of society who are tenants might have about security of tenure." (Makuch and Weinrib, 1985, p. 9)

Threats to security of tenure take two forms. The first relates to deliberate actions taken by landlords to evict tenants. It is discussed in section 4.5.1 under the heading statutory eviction. The second form relates to the difficulties of tenants who are economically insecure and is discussed in section 4.5.2.

4.5.1 Statutory Eviction

A landlord can seek to gain vacant possession of a unit as a prelude to demolishing or renovating the building in which the unit is located or converting it to another use (Landlord and Tenant Act, section 107). Vacant possession

58. Greater security of tenure is available to households through home ownership. For those who cannot afford to own, alternative mechanisms exist including co-operative housing. If increased security of tenure is deemed necessary for some segment of the tenant population, alternative housing forms may be a better approach than increased restriction of private landlords. Given the high mobility rate of Ontario tenants, it is apparent that security of tenure is not a concern of all tenants. See Recommendations in Chapter 6.

of a unit also may be sought for occupation by the landlord or a member of his family (Landlord and Tenant Act, section 110), and for non-payment of rent (Landlord and Tenant Act, section 108), or for cause such as disorderly behavior (Landlord and Tenant Act, section 109).

Prior to the passage of the Landlord and Tenant Act of 1969, a landlord's power to evict a tenant was limited only by the conditions of any lease contract which fixed the term of the tenancy. The 1969 amendments to the Landlord and Tenant Act greatly restricted the freedom of landlords to terminate tenancies at their discretion. The amendments did not go so far, however, as to prevent a landlord from resorting to economic eviction.[59] That threat to security of tenure was eliminated for most tenants by rent regulation in 1975. By limiting the amount of rent a landlord could demand, tenants who came under the protection of rent regulation were relieved from the threat of excessive rent charges and the prospect of being evicted if unable or unwilling to pay.

It is quite understandable that tenants may wish to be securely protected against arbitrary eviction if they are respectable and are paying the rent. However, there are other values which support a more pragmatic balancing of rights between landlords and tenants. If landlords' rights to the economic use of their properties are eroded too far, private investors will be unwilling to provide financing for rental accommodation with consequences prejudicial to both landlords and tenants. Liquidity is important to any investor and demolition and conversion provide liquidity for the investment. In addition, there comes a time in any building's life when its condition is such that it should be demolished or substantially renovated.

It is the view of the Inquiry that the Landlord and Tenant Act strikes a fair balance between the reasonable rights of landlords and tenants. Furthermore, in the absence of restrictive rent regulation, there would probably be little pressure for further changes to security of tenure provisions. However, as a consequence of Ontario's system of rent regulation, statutory provisions for security of tenure continue to be a contentious topic.

The most recent development by way of enhancing tenants' security of tenure has been the passage of chapter 26 of the Statutes of Ontario 1986, entitled "An Act respecting the Protection of Rental Housing" which became law on July 12, 1986. Under section 107 of the Landlord and Tenant Act a landlord can evict a tenant if possession is required for the purpose of demolition, conversion or extensive renovation of the rental complex. The exercise of that right is now subject to approval by the council of the municipality in which the property is located and any tenant facing eviction under section 107 can appeal to the Ontario Municipal Board and, if unsuccessful, to the government.

59. Economic eviction is discussed in section 4.2.2 above.

The virtue of chapter 26 presumably is that the local authorities, because of their close contact with the parties and familiarity with local conditions and the particular facts of each case, could be expected to exercise reasonable discretion in deciding on the merits of the landlord's application. The wisdom of subjecting landlords in these matters to supervision is impaired by the provision that, at the instigation of any tenant, the decision of the council can be appealed in a manner involving substantial expenditure of time and cost and in an increasingly political context.

It is a provision of chapter 26 that it is to be repealed in May 1988 but until then the landlord's chances of gaining possession under section 107 of the Landlord and Tenant Act are effectively neutralized. The projected repeal of chapter 26 in less than two years from its introduction indicates recognition of the fact that a policy of interfering with the property rights of landlords to the point of restricting the way in which they can use their property, will have adverse repercussions. The salient fact is that the credibility of the proclaimed intention to repeal the legislation is suspect. The original rent regulation legislation of 1975 contained the same repeal provision but after its life had been extended on several occasions it was overtaken by the 1979 Act. That Act as passed did not contain such a provision.

The chapter 26 extension of security of tenure goes beyond the psychological rationale cited above. It serves to reduce the loss to the market of existing rental housing which results from inadequate returns being earned by some investors.[60] It also serves to maintain the benefit to tenants of rents which are below fair market rents in rent-controlled buildings.

Rent review has depressed the general rent level and the profitability of older buildings to the point where there is a strong incentive to renovate, convert or demolish those buildings. Hence, as is discussed more fully in Chapter 1, one of the consequences of Ontario's system of rent regulation has been to aggravate the security of tenure conflicts. Buildings with rents which are significantly below the fair market rent level are the most attractive targets for renovation, conversion and demolition from the landlords' perspective. At the same time, the tenants in those low-rent buildings have the most to lose if they find it necessary to move since they are unlikely to find units with similarly low rents. Even those tenants who would not have an affordability problem in paying fair market rents for their units will be strongly opposed to any threat to their security of tenure. Even if the psychological costs associated with a move were not significant, the economic benefits of security of tenure are extremely valuable to tenants when their rents are depressed by regulation.

Under conditions where rents are fair market rents, the economic incentives for tenants to have their security of tenure increased would be eliminated.

60. See the discussion of restrictive rent regulation in section 3.1.1.1.

The only rationale for statutory security of tenure provisions would then be to protect tenants from arbitrary eviction, recognizing that the reasons for protecting tenants is that there can be psychological costs to moving. Where the landlord has no substantive reason for requiring possession of the unit, it is reasonable that tenants should not be arbitrarily evicted.

4.5.2 Economic Insecurity

In certain circumstances a tenant household's security of tenure may be impaired even in the absence of any eviction action by the landlord. The tenant household could decide to move when faced with a rent increase larger than it could afford to pay regardless of whether the increase is legitimate or is intended to force the tenant to move out.[61] Clearly, households whose socially fair rent is less than the fair market rent for decent, adequate housing, are those most threatened by economic insecurity. Security of tenure problems also could develop for households whose income suddenly falls behind the normal increase in living costs. Even those living in luxury units may find they can no longer afford to stay if their incomes are declining relative to their living costs.

This concern adds new dimensions to the problems already discussed in this Chapter. The difficulty some households may have paying their rent could be alleviated by moving to less expensive housing.[62] Even if suitable housing is available elsewhere at a rent they can afford, many persons — particularly the elderly who have lived in their home for many years — may be loath to move. This type of situation raises a particularly difficult social question. Should society assist immobile households with insufficient funds to afford the rent where they are or should they be forced either to move to less expensive accommodation or continue to spend more than they can afford on rent?

It also should be noted that programs which resolve the housing affordability problem of low-income tenant households do not necessarily respond

61. The problem of economic insecurity may be the result of the problem of excessive rent charges which are discussed in section 4.2, the problem of market fluctuations, which is discussed in section 3.5, or tenants' affordability problem, which is discussed in section 4.1. It may also arise if a tenant household with declining real income can no longer afford the fair market rent for the unit previously occupied, although it may be able to afford the fair market rent for alternate accommodation which is adequate. In that case, a household may suffer from economic insecurity although the difficulty is unrelated to the above mentioned problems.

62. That situation may result from a decline in income due to retirement or job loss, an inadequate fixed income on pension while inflation has increased costs, or other circumstances. The household previously may have been able to afford the unit but over time it has become unable to do so.

to their security of tenure problems. Some forms of assistance do not enable tenants to maintain their residence of choice because households are required to move if they are to receive socially assisted housing. Even if there were no obvious economic difficulties with the move, the psychological costs noted above could be high for some.

4.5.3 Policies for Protecting Tenants' Security of Tenure

With regard to statutory eviction, the Inquiry is of the opinion that section 107 of the Landlord and Tenant Act provides a balanced trade-off between the rights of landlords and tenants. That provision became law in 1969 before rent regulation was introduced in Ontario. At that time vacancy rates for rental housing were not extremely low as they are today and displaced tenants who were in a position to pay market rents could be expected to find new accommodation suitable to their needs at about the same rent they were used to paying. Chapter 26 not only extends the tenure of tenants occupying units in buildings coming within its range but protects those tenants' enjoyment of the low rents they are used to paying. It is the existence of less than fair market level rents which prompts landlords of those buildings to seek conversion, demolition or renovation of their properties.

What is called for is a moderate system of rent regulation which will allow the necessary action to restore the market to a better balance of supply and demand. The private market will not bring this about if the policy of government is to maintain restrictions on the economic planning of investors and landlords.

With regard to economic insecurity, it is clear that a rent regulation system which ensures actual rents do not exceed fair market rents is a valuable means of ensuring that responsible tenants are free from threats to the secure enjoyment of tenure due to excessive rent charges. Rent regulation also can go a long way in relieving the threat to security of tenure resulting from rapid rent increases in tight market conditions. However, households which have security of tenure problems because they cannot pay increases which are not excessive, are not going to be helped by rent regulation. If those households are to have security of tenure even when their incomes are insufficient to allow them to pay fair market rents, budgetary programs would be needed which would help them to avoid having to move to cheaper accommodation or into socially assisted housing.

In the Inquiry's view the security of tenure issue should be a consideration, but not an overriding one, in determining which form of budgetary program should be used to deal with the affordability problem of low-income households. Furthermore, it would not appear to be a realistic policy, whatever the social merit, to assist financially those households which can no longer afford

the rent for their current accommodation but who can afford the rent for more modest but still adequate accommodation. Given the limited resources available to government, there would appear to be competing programs which society in general would consider more important.

4.6 Substandard Housing

It is a widely held social value that housing should not only be available and affordable, but it also should be decent. This implies that all housing should meet socially defined standards.[63] The standards usually considered are the physical condition of the structure, safety measures, crowding and basic facilities such as indoor plumbing, hot water and heating. If rental accommodation does not meet these standards, it is deemed to be substandard.

Although media stories report on occupied dwellings in a physical condition below what is acceptable, none of the submissions to the Inquiry suggest that substandard housing is a widespread problem in Ontario.[64] The official statistics and reports regarding substandard housing in Ontario are reassuring. Available information[65] regarding household facilities lists such basic amenities as telephones, refrigerators, bathroom fixtures, running water and indoor plumbing (flush toilets). These are sometimes combined into indicators of general housing adequacy. For example, the Impact Study by MMAH (1982) based on the Household Income, Facilities and Equipment (HIFE) data, reports that in 1979, 99.6 per cent of dwellings in Ontario had running water, 99.3 per cent contained a bath or shower, 99.6 per cent had refrigerators and 99.1 per cent had flush toilets (p. 112). The numbers seem to indicate that on the whole Ontario's population is well housed. Miron and Cullingworth (1983) conclude after examining the data on housing quality nationally: ''Canadian housing is generally of high quality, and the traditional measures of inadequacy (largely related to plumbing and heating) are no longer 'sensitive'.'' (p. 94)

Although statistics on household facilities are used as the principal indicator of housing quality, they do not provide a complete picture. One government study cautions that: ''there is little correlation between this indicator

63. Section 96(1) of the Landlord and Tenant Act 1969 (and the aborted section 28(1) of the Residential Tenancies Act 1975 that was to have replaced section 96(1)) declares that ''a landlord is responsible for providing and maintaining the rented premises in a good state of repair and fit for habitation during the tenancy and for complying with health and safety standards including any housing standards required by law...''

64. As an indicator of housing quality, adequacy data may be useful in identifying particular substandard areas and poorly housed groups. For example, see the discussion concerning the poor and near-poor in rural and urban areas in Steele and Miron, 1984, pp. 35-36.

65. The principal sources of information on standards are the Census and the HIFE survey.

and structural housing adequacy, possibly because of the low incidence of dwellings without basic facilities in large urban areas.''[66] One reason for the emphasis placed on facilities is that it is far easier to determine whether basic facilities are provided than it is to assess the physical condition of structures. Either indoor plumbing and fire alarms are provided and are operational, or they are not. Determining the adequacy of the physical condition of the building, however, is a subjective matter which relates as much to expectations as to objective criteria.

Several housing surveys have attempted to estimate physical inadequacy by measuring the number of rental units in poor condition. CMHC's 1974 survey of housing units estimated the incidence of poor quality housing for nine Ontario cities. Toronto, for example, had an incidence of five per cent. The 1981 Census tabulated figures on dwelling conditions by asking tenants whether their buildings needed regular maintenance and minor or major repairs. About seven per cent of Ontario's tenant households reported that major repairs were needed while 17 per cent believed minor repairs were necessary. CMHC (1983) observes that across Canada the incidence of physically inadequate rental dwellings declined from 1.9 per cent in 1976 to 1.0 per cent in 1980.

In many municipal jurisdictions, particularly large urban centres, housing by-laws govern ''minimum or satisfactory'' housing standards. For example, The City of Toronto Housing By-law (No. 73-68) covers such features as structural stability, weatherproofing, sanitary conveniences, electrical supply and outlets, and limited space requirements.[67]

Another indicator of the adequacy of housing is crowding. That measure, however, is different from the others discussed in this section since it is not a physical characteristic of housing units but a measure relating to how they are used. Overcrowding is an indicator of availability and affordability. The elimination of overcrowding requires more than restrictions on how units may be used. It is also necessary to deal with the affordability and availability problems already discussed.

There is no common understanding of what is meant by crowding. One definition is given by Pringle (1986) as being a situation where there are more persons in a dwelling than there are major rooms, where major rooms do not include washrooms and halls. Burke et al. (1981) estimate that four per cent of urban Canadian households lived in overcrowded conditions in 1974. CMHC in 1983 found that among tenant households, crowding — like physical inadequacy — declined between 1976 and 1980 from 3.4 per cent to 1.9 per

66. Canada. *Projecting Long Term Housing Requirements and Assessing Current Housing Needs: The Canadian Experience*. 1978, p. 16.

67. The City of Toronto Housing By-law is summarized in the Social Planning Council of Metropolitan Toronto, *Guides for Family Budgeting, 1984*, pp. 46-52.

cent. Available Census estimates indicate somewhat higher figures for 1981. About three per cent of the tenant households in Ontario reported having more than one person per major room.[68]

There are obvious limitations with regard to the above surveys. The standards of adequacy are arbitrary and the different surveys use different criteria and assessment techniques. Nevertheless, it is a widely accepted responsibility of government to establish and enforce minimum housing standards. In doing so, however, it must be recognized that meeting standards imposes costs on landlords which inevitably are reflected in rents. As a result, the affordability problem of low-income households may be aggravated, a fact which must not be overlooked when developing policies aimed at improving the quality of the housing stock.

4.6.1 Policies for Upgrading Substandard Housing

The most direct way to respond to the problem of substandard housing is to prescribe objective housing standards by legislation or regulation.[69] Landlords who are responsible for the existence of substandard housing then can be subjected to various types of sanctions. That approach has been used by all levels of government for many decades. Enforcement orders may be made by a judge under section 96 of the Landlord and Tenant Act directing landlords to remedy specific problems. These procedures are discussed under the heading institutional policies in Chapter 3. In the opinion of the Inquiry they are appropriate remedies for the problem of substandard housing.

The 1986 Act extends the range of sanctions which can be applied to landlords of substandard housing.[70] Section 15 of the Act provides that legislated and regulatory standards may come under consideration by the Residential Rental Standards Board created by the Act which can determine whether a standard is ''substantial''. The Standards Board may also determine in a

68. Pringle (1986) observes:

> Households earning between $20,000-$25,000 had the highest incidence of crowding, those earning between $5,000-$10,000 the lowest. To some extent, this may be explained by the greater percentage of socially-assisted housing among low-income groups. (p. 126)

In the Toronto CMA, the incidence of crowding was 3.84 per cent. In all other Ontario CMA's, the incidence of crowding was between one-quarter and one-half of the incidence in Toronto.

69. For example, standards are established by means of federal and Ontario building codes and municipal housing standards by-laws.

70. The 1975 Acts contained provisions for dealing with declining maintenance. That is different from the problem of housing which fails to meet a minimum standard. The problem of declining maintenance is addressed in section 4.9 below.

particular case of alleged non-compliance whether there has been "substantial non-compliance with substantial standards." If so found, the rent increase to which the landlord might have been entitled may be deferred by the Minister until there has been compliance.

Fines normally are levied on the basis of legislated limits and the discretion of the courts with the intent of imposing fines based on the severity of specific offenses. To defer a rent increase to force landlords to comply with housing standards is equivalent to imposing a fine but the amount of the penalty is determined by the amount of the increase which otherwise would be permitted.

The enforcement of housing standards should not be considered an objective of rent regulation. Standards should be enforced directly through sanctions such as fines. If the existing sanctions are not strong enough to ensure compliance with housing standards, the obvious response is to make those sanctions more severe. To reduce the rents a landlord may collect could be counterproductive in that it could legitimize a landlord's claim that the rents are insufficient to support expenditures for improvements.

As noted above, the enforcement of housing standards can aggravate affordability problems. As a consequence, it is important that adequate assistance be available to low income households to ensure they can afford housing which meets all standards. The policies for easing the affordability problem of low income households discussed in section 4.1 will respond to this concern. Clearly, some form of shelter allowance is required to ensure that all low income households with an affordability problem, and not only those who gain admission to socially assisted housing, receive the financial help necessary to allow them to afford housing which is not substandard.

It also may be possible to deal with the problem of substandard housing by removing substandard buildings from the market. If that is done, however, many of the displaced tenants will likely need socially assisted housing or some form of income assistance.

In addition to sanctions, the response to substandard housing can be financial assistance to landlords to upgrade their buildings. The consequence of improving the property would probably be a move on the part of the landlord to raise the rents which might exceed the resident tenants' capacity to pay. Where the landlord has been subsidized, any rent increase should be regulated so that the rent would not exceed a fair market rent net the value of the subsidy. Some tenants might be unable to pay the regulated rent and for them financial assistance would be required.

4.7 Availability of Capital

The preceding sections examine problems which are considered by at least some people to be characteristic of unregulated rental housing markets. This

section and the next two examine problems which are not normally concerns when rents are unregulated, but may emerge as problems with restrictive forms of rent regulation.[71] In particular, they appear to be consequences of the Ontario system of regulating rents which has been in place since 1975.[72]

The problem dealt with in this section is the shortage of private sector capital committed to rental housing. For the private sector to invest in the rental housing market, developers and landlords must expect to earn a competitive return on their investment.[73] When rent regulation holds the expected industry return below the competitive rate of return in the long-run, sufficient capital will not be available for maintenance and conservation[74] of the existing stock or for construction of new rental housing units. Not only will individuals and corporations be unwilling to commit equity funds to the development of rental housing, but financial institutions will not provide sufficient debt financing to make conservation and construction projects possible.[75]

In the private sector, the imperatives of the marketplace cannot be ignored. An investor's first concern must be to ensure that the costs of operating the property, maintaining it in a good state of repair, paying taxes and paying interest on debt financing are covered by the rental income. As well, cash flows should be adequate to ensure that over and above meeting those recurring expenditures there will be funds to pay the capital and financing costs of major conservation measures when necessary. Finally, the investor must anticipate earning adequate compensation for the time and effort expended in managing the property and a return on the personal equity investment.

Determining the numerical amount of the minimum rate of return adequate to attract sufficient capital into the rental housing industry to ensure future supply, involves techniques which have been studied and developed to a high degree of sophistication.[76] At the centre of the issue is the fact that the landlords'

71. As discussed in section 3.1.1 these problems are unlikely to result from moderate forms of rent regulation.

72. See the discussion of the consequences of the Ontario system of rent regulation in Chapter 1.

73. A landlord is seen by the tenants as a property manager but essentially a landlord is an investor in property although the property must be managed in order to protect the investment. The funds for the landlord's investment may have been derived wholly from personal resources but almost invariably some part and usually the major part is borrowed. The lender is a co-investor but ordinarily has no contact with the tenants.

74. For discussion concerning the distinctions between conservation and maintenance see Stanbury and Vertinsky (1986, pp. 6-64 to 6-68) and the testimony of W. Stanbury, Transcript 96-2, pp. 3-16 and J. Klein, Transcript 129-2, pp. 7-19. Also see Appendix G.

75. Environics Research Group Ltd. (1985) examines the impact of Ontario's system of rent regulation on the availability of capital for residential rental accommodation.

76. Methods of determining required rates of return have been intensively studied because they

expected returns must exceed the return which can be earned on a lower risk investment by a sufficient margin to compensate for the additional risk borne by investors in rental housing.[77]

It is important to recognize that it is the expectations of investors which determine the availability of funds for investment, not the actual historical returns. Although investors cannot accurately anticipate future returns precisely at the time of making an investment, they have expectations based on their views of economic, political and other factors.[78] If potential investors in rental housing see that a regulatory scheme reduces the return earned by existing landlords to less than the competitive rate of return,[79] it will signal a similar risk to potential investors even if rents for new buildings are not initially restricted. Investment in rental housing will not be forthcoming unless investors — both large and small — have a reasonable expectation that, under the regulatory system likely to prevail, they can earn a competitive rate of return.

Furthermore, if investors anticipate changes in the system but are unsure exactly what changes will occur and what their effect will be, the political risk will be high. The level of political risk compensation required in the expected return also will be high. A system which is not seen to be fair to both landlords and tenants is unlikely to be regarded as a stable regulatory system. To minimize political risk it is necessary to maintain a regulatory system which is accepted as being fair and viable in the long run. In addition, the government should show a strong commitment to maintaining the rules, at least as they apply to properties developed under those rules. Doing so will minimize political risk, thereby minimizing the political risk premium in the required rate of return. A lower required return implies a lower cost of capital and ultimately lower rents for tenants.

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serve an important role in the rate-setting process in a number of regulated industries. For example, they have been used in some jurisdictions for the purpose of setting rates for public utilities such as water, gas and electric power, telephone and telegraph service and air and rail transportation (Quirin, 1986, p. 61).

77. Quirin (1986) identified four components of the return earned on equity investment: the real risk free rate under conditions of no uncertainty as to future price levels; compensation for the consensus level of prospective inflation over the term of the investment; compensation for accepting uncertainty as to future price levels; and compensation for risks borne by equity investors with minimal inflation risk. (p. 213)

78. The same considerations are relevant both to the availability of new investment and the retention of existing investment. However while it is possible that existing physical capital can be locked in by restrictions on conversion and demolition, this cannot be done to future investment which must be attracted by the expectation of an adequate return.

79. Regulation affects both expected profitability of investment in rental housing and the perceived risk which is a factor affecting the competitive rate of return for investment in rental housing.

It also is important to recognize that for many investors in rental housing, particularly the smaller ones, a viable investment must earn not only an adequate return, but the return must be earned in such a way that the annual cash flow generated must be adequate for financial survival. Many small landlords live on the net income from their rental units. That income includes both the return earned on their equity investment and compensation for the time and effort they put into managing and maintaining the building. In effect, the landlord is paid for the work of operating the building rather than a superintendent, cleaning staff and repairmen, all of whom are employed by large landlords. It is important that small landlords are compensated for their "sweat equity" as well as their financial equity, or they will be driven out of the market. At the present time they account for a significant portion of the total rental housing supply, particularly in the low-price range.

The cash flow also is an important consideration since managing a rental building is not the same as buying a government bond where once the initial investment is made, no additional funds are required. A landlord faces many major expenditures, the timing of which is to some extent unpredictable. The roof and the plumbing and electrical infrastructure, for example, have to be replaced or renovated periodically, and funds must be available to cover the outlay. If the cash flow is adequate, the landlord may set aside some amount each year in anticipation of such expenditures. Otherwise it may be necessary to borrow funds, but that can only be done if the lender considers the cash flow to be adequate to ensure repayment of the loan with a reasonable cushion for unexpected circumstances.

A system which deters private sector investment in Ontario's rental housing market is not acceptable. There will be a substantial requirement for additional capital in the foreseeable future because population growth and changing demographics will increase demand beyond present levels. In Foot's (1986) study of the future of housing in Ontario he suggests on the basis of what he calls illustrative calculations:

> That the rental housing market in Ontario over the next 20 years might require, on average, the addition of:
>
> — 10 to 15 thousand units a year to cover new demand;
>
> — perhaps, 2 to 3 thousand units a year to provide some "cushion" on vacancy rates;
>
> — up to 25 thousand units a year to cover demolitions of existing units (net of renovations); and
>
> — perhaps, up to 5 thousand units a year to cover conversions to non-rental units. (p. 120)

Funds to provide these new units must be made available if tenants in Ontario are not to face a critical housing shortage in future years. Private investors will be needed to provide a significant portion of the rental market's capital requirement.

The key point for purposes of this Report is that if the prospective return on investment is not competitive with alternative opportunities with similar risk, there will be a problem with availability of capital for new supply and for maintenance and conservation of the existing stock. For the industry to earn a competitive rate of return it is necessary that the rents be fair market rents.

4.7.1 Policies to Increase Availability of Capital for Rental Housing

Because restrictive rent regulation is the major cause of inadequate capital, a necessary concern of rent regulation policy must be to institute a moderate system of regulation so that it will not interfere with the flow of capital investment. For the system of rent regulation to be moderate, the actual rent level must not be held below the fair market rent level.

The consensus of informed opinion is that in Ontario, rents on average are currently below the fair market level. To stimulate an adequate supply of private capital to meet the needs of the rental housing market, it is necessary that rents be restored to a fair market level. If any move were made in that direction, rents in some instances would be increased by more than just an annual inflation adjustment, although where the increase would be substantial it could be phased in over a period of years. In most instances the increased rents of middle and upper income tenants and possibly even of some lower income tenants would not exceed the households' socially fair rent limits. The tenant household with an affordability problem should receive financial assistance, as discussed in section 4.1, in order to protect low-income tenants from suffering increased hardship as rents rise to the fair market level.

Of course, given the political sensitivity of the rent regulation issue and the frequency with which Ontario's system has been changed, investors may not react immediately to the introduction of a moderate system of rent regulation. Until investors are reasonably confident that a new system of moderate rent regulation will not be altered so as to make it restrictive, many will be hesitant to invest. Either rents will have to be high enough to compensate investors for the perceived political risk or else government will have to maintain its policy of moderate regulation for a long enough time to establish investor confidence in the continuation of that policy. As a consequence, the intractable question is not how to devise a regulatory system which will attract private capital investment back into rental housing, but how to assure investors that

if such a system were adopted, government would allow it to continue to operate.

The transition from restrictive rent regulation to a moderate system will not be easy and government will be under strong political pressure from tenants in all income ranges to adhere to the restrictive system because of the apparent immediate benefit it confers. Government will have to accept the necessity of ensuring that investors in the rental market are able to operate on a sound financial basis.

As matters now stand deficiencies in the funds required to finance conservation measures and new supply must be made up by public funding. It is the objective of budgetary housing policies to ensure that such capital is available. It is evident from recent vacancy rate statistics, however, that government has not been willing or able to commit sufficient funds to rental housing to fully compensate for the effects the current regulation system has had on rental housing investment. There is no indication that government funds available for rental housing can be increased sufficiently to resolve the problem in the foreseeable future. Hence, relying on government to provide the investment needed to sustain the rental housing market is not a satisfactory alternative to moving to a moderate system of rent regulation.

Budgetary programs would be an invaluable adjunct to the introduction of a moderate system of rent regulation, at least in the short term. In the early years of a new regulation program, incentives would help ensure that adequate capital is available for investment in conservation and new construction. The longer the program remains in place, the greater the confidence investors will have that it will not be tampered with in response to short-run political pressures. Consequently, the need for government incentives would decline over time.

From a policy point of view, availability of capital, availability of rental housing and the level of maintenance and conservation are separate isssue, although the latter two problems clearly are effects of the unavailability of capital. The following two sections examine those issues.

4.8 Availability of Rental Housing

In general, if capital is available to build new units and landlords do not withdraw capital from the rental market by demolishing or converting their buildings, there will be an adequate supply of rental housing. Nevertheless, for certain segments of the market, supply problems may arise even if capital is not restricted. Consequently, rental housing availability is treated as a problem distinct from availability of capital.

In this Report, an availability problem is considered to exist when tenants are unable to find accommodation readily although they are willing and able

to pay the fair market rent for suitable units supplied by the private market. Households which cannot find accommodation because they cannot afford the fair market rent for housing suitable for them, are considered to have an affordability, rather than an availability problem.

The way the market operates is that in the absence of restrictive price regulation, a rental housing availability problem would be self-correcting. In the normal course of events in the market, the rent level will reflect the cost of constructing and operating rental buildings; hence, the profitability of investment will be maintained at a level sufficient to attract investment and maintain an adequate supply. If market demand should outgrow supply, creating an availability problem, rents will be driven up to a level at which additional investment is attracted into the industry resulting in new supply. When the availability problem is eliminated by that additional supply, rent increases will moderate, profitability will return to normal levels and the rate of new investment will slow down to match the rate at which demand is growing. A similar self-correcting mechanism comes into play when supply outgrows demand leading to an oversupply of rental housing.[80]

Supply shortages may occur for a number of reasons. Demand may grow more quickly than anticipated due to unexpected demographic or economic changes. New supply may be inhibited by economic factors such as high interest rates or by delays due to anything from weather to the approval process for new developments. Supply shortages also will occur if rent levels are artificially depressed since landlord returns will be below the competitive rate of return and investors will be unwilling to invest in rental housing. Finally, even if the rents chargeable for new units are not restricted but investors perceive a risk that the rents they will be permitted to charge in the future will be restricted so that they will earn less than a competitive return, investment in rental housing will be less attractive than alternative opportunities. Hence, there may be an inadequate supply of new rental housing.

Some industry representatives and the authors of several research studies who appeared before the Inquiry submitted that by depressing rent levels for the pre-1975 rental stock, rent regulation in Ontario has created an availability problem in many cities. Controls have reduced rents and the profitability of investment in rental housing. Although rents were not controlled in new buildings, the mere risk of controls being extended (which has now happened) lowered the income expectations of landlords and discouraged new investment. They also submitted that if controls were removed so that landlords and developers could expect to collect a fair market rent, an adequate supply of rental

80. The operation of the market is discussed in more detail in Stanbury (1985a, Ch. 4), and Muller (1986, Ch. III).

housing would become available[81] and public money would not be needed to subsidize the provision of housing for tenants who can afford fair market rents.[82]

The objective of making an adequate supply of rental housing available involves more than simply making sure there are as many housing units in the market as there are households. It involves matching the diverse needs of all those who desire to rent and can afford to pay fair market rents with accommodation which meets their requirements. It also involves meeting the needs of all those who cannot afford the fair market rent for suitable accommodation, but are entitled to assistance in accordance with social policy. When there is an adequate supply of housing, not only would every household be adequately housed, but there would be a high enough vacancy rate to enable households to move to more suitable housing should their needs or their economic resources change.

4.8.1 Measuring Rental Housing Availability

The most widely used indicator of rental housing availability is the vacancy rate. It is the percentage of the supply of rental accommodation which is unoccupied. Experience in the rental housing market has led to a rule of thumb that a vacancy rate of something in the range of two to five per cent is normal.[83] A vacancy rate in that range maintains a balance between supply and demand which avoids both excessive rent increases and excessive depression of rent levels.

A normal vacancy rate enables prospective tenants to find suitable accommodation at a fair market rent without difficulty. Furthermore, incumbent tenants have ready access to other accommodation should their financial po-

81. See the testimony of J. Bassel, Transcript 125-2; A.E. Diamond, Transcript 127-2; A Friedberg, Transcript 103-2; P. Goring, Transcripts 118-2 and 127-2; and A. Richman, Transcript 137-2.

82. See the discussion in section 4.7, availability of capital which argues that it will take some time before the confidence of investors in the government's determination to stick to a moderate system of rent regulation is regained. In the meantime, investors will be reticent to invest even if rents are at the fair market rent level, unless that fair market rent level includes compensation for the political risk that the regulatory system will be altered to make it more restricitive.

83. The natural vacancy rate is that rate at which the rental housing market is considered to be balanced and stable. Smith (1974) estimated that the natural vacancy rate is five per cent for Toronto, Winnipeg and Vancouver, and 5.6 per cent for Halifax. Lett (1976) refers to a five per cent rate for American cities. More recently, Clayton (1984) comments that:

> A vacancy rate of 2 to 3 per cent in the Canada Mortgage and Housing Corporation's semi-annual survey has been regarded as indicative of a balanced rental market. (p. 14)

See also Muller (1984) p. 112.

sition or their housing requirements change.[84] When landlords know that tenants can readily find other accommodation, they exercise restraint when increasing their rent.[85]

The primary source of vacancy rate data is the vacancy surveys conducted by CMHC each April and October.[86] It may be observed that since 1975 when rent control was introduced in Ontario the vacancy rate trend-lines have been downward in most urban centres in Ontario and availability problems have become increasingly acute. That can be seen from Table 3 which presents data from four metropolitan areas in Ontario for which data are available. The point also is illustrated in Figure 1.

Similar trend-lines have not been observed elsewhere in Canada, as is shown in Table 3, nor have they been observed in the United States.[87] It was noted during the course of the Inquiry that several economic and other factors have contributed to the decline in housing starts in recent years.[88] However, those factors by themselves do not explain the ongoing tightness of the rental market. In the opinion of the Inquiry, rent regulation has been the largest single factor contributing to low vacancy rates in Ontario.

4.8.2 Availability of Socially Assisted Rental Housing

Availability tends to be a more serious problem for low income households than for higher income households since for the former the choice of units is limited. A vacant unit renting for $800 a month is not available to tenants who

84. Muller (1986) observes that availability is a necessary feature of distributional efficiency which in turn is a component of economic efficiency, the latter being a criterion for evaluating the performance of an economic market. As he puts it, "...distributional efficiency requires enough vacant units to allow renters to move easily to rental housing that is appropriate in size, location and quality." (pp. 11-12)

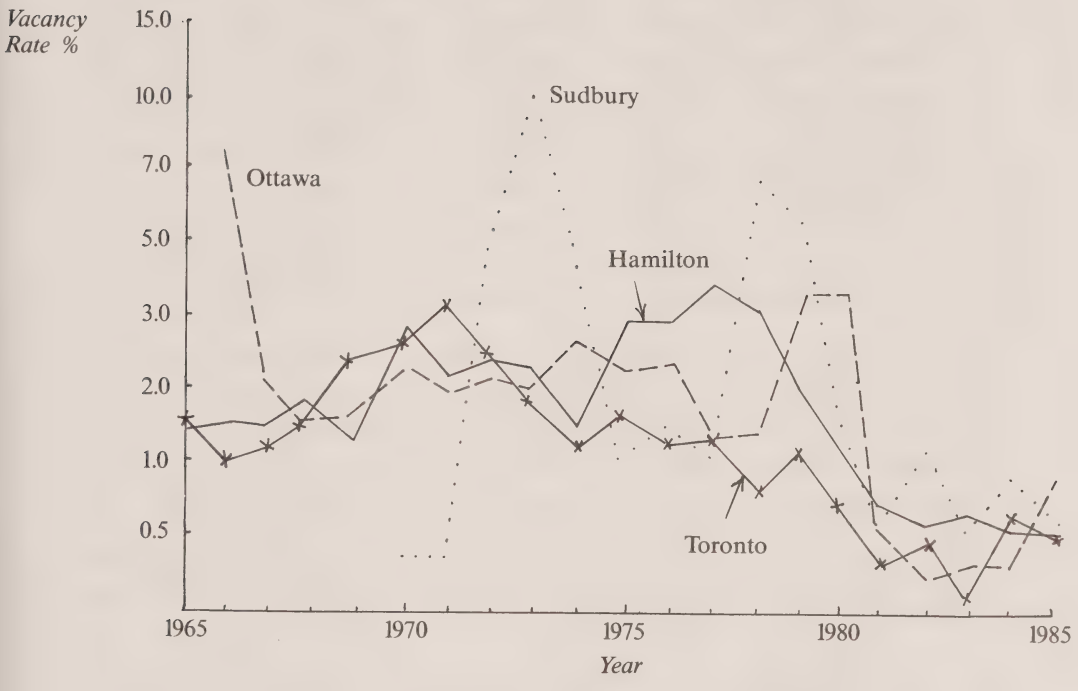
85. The existence of tenure discounts (reduced rates of rent increases for existing tenants) is noted in Adams, Ing and Pringle (1986, pp. 44-45), Stanbury (1985a, p. 4-25) and Steele and Miron (1984, pp. 44-45).

86. CMHC vacancy rate data should be used cautiously as an indicator of rental housing availability since they provide an incomplete picture of overall rental housing availability. That is the case for three reasons related to the manner in which the CMHC statistics have been compiled and reported. These reasons are dealt with at length in Appendix F.

87. For data on U.S. cities see Tables 4, 5 and 6 and Figures 5 through 8 in Appendix F.

88. Included in these are financing and construction costs, changes in household income and rates of new household formation, condominium rentals, government subsidies to private rental projects, changes in tax legislation and in landlord-tenant legislation. See Chant (1986, Ch. 5-7), Clayton (1984, pp. 16-18), Hulchanski (1984, pp. 45-56), Muller (1986, pp. 16-18), Stanbury and Vertinsky (1986, pp. 6-68 to 6-85) and the testimony of J. Bassel, Transcript 97-2; A.E. Diamond, Transcript 127-2; M. Nairne, Transcript 104-2 and W. Stanbury, Transcripts 96-2, 98-2 and 99-2.

Figure 1: **Rental Vacancy Rates[1] for Selected Metropolitan Areas, Ontario, 1965-1985**



NOTE: 1. For privately initiated buildings containing 6 or more units. Excludes buildings constructed within 6 months of the survey dates. Data for 1965 to 1968 are for June, thereafter the estemates are averages of the twice yearly surveys. (April and October)

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey,* various years; and Figure 1, Appendix F.

can afford to pay only $400 a month. Furthermore, the problem of availability of low-priced units is difficult to resolve because the private sector cannot build unsubsidized rental units which meet the housing standards laid down by the several levels of government and make them available at a rent lower income households can afford. The poor and the near poor[89] simply do not have the means to pay rents which meet the economic cost of housing suitable

89. Steele and Miron (1984) refer to those households with incomes below the Statistics Canada low-income cut-off as poor and those households with incomes between the low-income cut-off and twice that level as the near-poor.

for them.[90] As a consequence, any excess demand for low-cost housing cannot be resolved by private sector construction.[91]

For households which cannot afford the fair market rent for adequate accommodation, the problems of availability and affordability are closely related. If neither socially assisted housing in which rents are geared-to-income nor a shelter allowance program is available to low-income households, they are forced to take what accommodation they can get even though the rent takes an excessive part of their income.[92] They have an affordability problem but it can also be said that suitably priced accommodation is not available. Many low income households inevitably will be denied access to private market accommodation unless they have some form of assistance. Either those households must be given income supplements to make fair market rents affordable, or else housing must be made available to them at rents below the fair market level.

Two estimates (Steele and Miron, 1984, and CMHC, 1984) placed the number of renter households with an affordability problem at around 165,000 province-wide in 1981. Muller (1986), in concluding the review of affordability estimates, suggests between 150,000 and 200,000 Ontario renter households were in core need.[93] Particular groups in need are low-income families with children (with one or both parents present) and elderly households. Additional affordability problems arise among low-income single people (roomers and lodgers).[94] As of 1984 there were approximately 172,700 socially assisted units

90. Marcuse (1978), Marks (1984) and Steele and Miron (1984) observe that if there is a limited supply of lower quality housing at low rent, some low-income households will be forced into units which are priced higher than they would rent by choice.

91. This concern relates to the issue of excess profits on low-rent housing. If there is excess demand for older buildings when they are rented on a cost-recovery basis, in an unregulated market rents will rise causing households to accept newer, more expensive units and landlords will earn excess profits. In a regulated market, rents may be held down and the problem will manifest itself as a housing shortage with more households seeking that type of unit than there are units available.

92. At the extreme of that part of the population there are the literally homeless, almost always individuals with no possessions or property rights and no family obligations. They are a class apart and present a special social problem to which the residential tenancy policies under review in this Report have little or no relation. For households in the category of core need it must be assumed there is accommodation of some sort simply because they are not found living on the streets or in hostels. In some instances the accommodation in which they are living may be inadequate and below acceptable standards (see the testimony of E. Heyworth, Transcript 133-2, pp. 13, 51 and 69) but the data with regard to substandard housing (see section 4.6 above) lead to the conclusion that the quantity of such housing is quite small.

93. See Table 2 in Appendix C and the discussion above in section 4.1

94. Jaffary (1984) estimates the number of roomers and lodgers at about 80,000.

TABLE 3: Vacancy Rates(1) in Metropolitan Areas, Canada, 1965-1985 (Percent)

Area	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Ontario																					
Hamilton	1.4	1.5	1.4	1.9	1.3	2.2	2.2	2.2	2.3	1.9	2.4	3.1	4.3	3.9	2.5	1.5	0.9	0.6	1.0	0.7	0.4
Ottawa	—	7.7	2.2	1.5	1.5	1.9	1.8	2.0	2.1	3.4	2.3	2.1	1.7	1.5	3.0	3.9	1.4	0.3	0.3	0.3	0.9
Sudbury	—	—	—	—	—	0.3	0.3	5.2	10.5	6.9	2.1	1.2	1.2	5.4	8.5	2.7	1.3	1.1	1.2	0.9	0.8
Toronto	1.6	1.0	1.2	1.5	2.5	2.8	3.3	2.9	1.8	1.1	1.5	1.3	1.1	0.9	1.2	0.8	0.4	0.6	1.1	0.7	0.5
West																					
Calgary	8.0	5.8	1.6	1.3	1.8	6.3	8.7	7.8	8.3	3.4	1.2	0.3	0.2	1.0	1.0	0.7	0.5	4.1	12.0	11.7	4.8
Edmonton	6.5	2.8	2.8	2.8	3.0	3.8	5.7	6.8	6.8	3.2	0.6	0.1	0.2	0.8	2.5	2.0	1.8	4.0	8.5	10.5	5.9
Regina	—	—	—	—	10.7	10.7	6.6	2.1	1.3	0.4	0.1	0.3	0.8	2.3	2.8	1.4	1.2	0.7	2.4	2.4	3.5
Vancouver	4.0	1.5	1.0	1.3	1.0	2.4	3.5	1.5	0.7	0.2	0.2	0.6	1.6	1.5	0.6	0.1	0.1	1.3	2.0	2.3	2.5
Winnipeg	4.9	4.1	1.7	1.6	1.7	3.0	4.6	4.9	3.8	2.3	1.9	1.5	1.5	2.8	4.8	5.0	3.9	1.8	1.2	0.9	0.9
East																					
Halifax	5.4	3.8	2.8	0.5	0.6	2.9	3.9	3.3	2.4	2.5	2.1	1.9	2.3	2.3	2.7	1.9	0.7	0.8	1.5	0.7	0.7
Montreal	—	4.5	1.2	5.0	6.7	7.3	5.8	4.3	2.9	1.9	0.9	1.0	2.5	4.5	4.5	3.5	2.0	2.2	2.9	2.6	1.8
Quebec	—	4.8	2.2	2.2	2.8	2.9	4.4	5.5	4.1	3.2	1.3	0.8	1.4	2.6	3.8	2.8	1.9	3.3	4.5	2.6	1.4
Saint John	—	—	—	—	0.5	2.3	1.0	1.1	1.2	0.7	0.5	5.8	8.8	7.2	3.2	3.4	3.3	3.5	4.0	4.6	3.7
St. John's	—	—	—	—	17.2	20.7	3.6	0.5	0.3	0.5	2.1	2.5	3.6	9.3	4.0	1.2	1.2	4.4	4.7	3.3	2.9

Note: 1. For privately initiated buildings containing 6 or more units. Excludes buildings constructed within 6 months of the survey dates. Data for 1965 to 1968 are for June; thereafter the estimates are averages of the twice yearly surveys.

Source: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, various years.

in the province. Of these about 105,500 units were limited dividend (29,500) and Ontario Housing Corporation (OHC) public housing (76,000) units in which rents are geared-to-income; 41,600 were non-profit units; and 12,000 were co-operative units.[95] Only about one-third (approximately 17,900) of these units are available to those most in need. Most of the public housing and limited dividend units were built by 1976. The emphasis since then has, increasingly, been on the construction of non-profit and co-operative units and integrated housing.[96]

OHC housing is limited to senior citizens, families with children and disabled persons. While low-income families represent a target group for housing assistance, the Ministry reports that more than 60 per cent of the geared-to-income units in 1982 were bachelor and one-bedroom apartments.[97] One crude indicator of a gap between the demand for and supply of socially assisted units is the waiting list for accommodation.[98] In 1982 there were over 24,900 family and senior citizen households in total on OHC waiting lists. This has declined somewhat since then. As of June, 1985, there were 21,800 households on the waiting list comprised of 16,411 family and 5,397 senior citizen households.[99]

4.8.3 Policies to Increase the Availability of Rental Housing

Rent regulation can serve no positive role in alleviating the availability problem. Rent regulation can only deter new investment in anything from a flat in a private home to a multi-unit high rise. Nevertheless, a moderate regulatory

95. The remaining units were developed under Municipally Assisted, Assisted Rental and Private Assisted Rental programs. See Muller (1986), Table 2.7, p. 40.

96. See CMHC (1983) and a Study Team Report to the Task Force on Program Review (1985). The non-profit and co-operative housing programs were designed to serve a mix of income groups. Currently the majority of units are built to rent at low end of market or at market levels. Residual assistance goes toward rent-gearedto-income units. Within the programs the proportion of units with rents which are rent-geared-to-income varies depending on whether the individual project is initiated by a municipal non-profit, private non-profit or co-operative group and, in some cases, whether or not provincial assistance specifically aimed at assisting low-income households is added to federal assistance. The assistance to low-income households may or may not be extensive. This affects the total number receiving assistance.

97. MMAH (1983) Table 33, p. 60. Bachelor, one and two bedroom units comprised 14.8, 47.0 and 15.8 per cent respectively of the rent-geared-to-income stock. For additional detail on the distribution of socially assisted units by program, structural type and household type see MMAH (1983), Muller (1986) and Pringle (1986).

98. Waiting list numbers are rough measures since not all families requiring assistance would register because lengthy waiting lists and the eligibility criterion may be a deterrent.

99. OHC waiting list, Exhibit 72, Sept. 13, 1985.

program designed to remedy faults in the operation of the market should not unduly inhibit private investment. Such a program would be an important first step toward relieving the current shortage in the supply of new rental housing.[100] Regulatory programs are relevant to rental housing availability only in so far as they do not impede the operation of market forces which are conducive to providing new supply and maintaining and conserving existing supply.

It is evident that an availability problem exists in many parts of Ontario, particularly is the larger cities and particularly for lower income tenants. Both theory and empirical evidence from other jurisdictions indicate that the availability problem, as measured by aggregate vacancy rates, would be relieved over time without government assistance if a scheme of rent regulation were introduced in Ontario which allowed landlords a competitive rate of return on their investment. However investors view the permanence of any favorable changes to the regulatory system skeptically. The low level of investor confidence, plus the time periods involved for large-scale development, make it unlikely that the availability problem will be relieved within a reasonably short time period. Consequently, availability problems can be expected to persist unless government provides incentives which make investment attractive despite the political risk perceived by investors.

Budgetary programs are needed to relieve immediate availability problems. Two such types are demand and supply augmenting programs. Demand programs exist as direct financial payments to tenants, often referred to as shelter allowances. By putting funds into tenants' hands, these programs have the potential for inducing low-income households to move to better and more suitable housing. This could be expected to stimulate the demand for new housing investment. Supply augmenting policies are direct financial inducements to encourage private and cooperative investment in new housing. These can take the form of loans at reduced rates of interest, subsidized building supplies or direct construction subsidies. It would be a matter of government policy whether builders and developers should make subsidized rental housing available to tenants generally or mainly for low-income tenants. In the latter case some further public funding would be required to make up the difference between the tenants' socially fair rent and the economic rent required of the unit.

Supply programs can also take the alternative form of funding publicly owned and operated non-profit housing usually under municipal auspices. Such housing is referred to as socially assisted housing. As with subsidized private rental housing, the major problem for government is whether socially assisted housing should be available to households generally or be restricted to core

100. Note the importance of the allowing current landlords to earn a fair return in order to maintain the confidence of potential investors that they will be permitted to earn a fair return in the future. This point is discussed in section 4.7.

need households. The history of such housing has been that so-called public housing has been open only to needy households. If their financial position improved to the point where they could pay market rents, the policy in principle at least was that they should vacate the premises. Non-profit, socially-integrated housing however, as its name indicates, is designed to be available to moderate income as well as low-income households. The former pay low end of market rents, which in fact may not be the full economic rent, while the latter pay an income-tested rent which is similar in concept to a socially fair rent.

Future policy regarding both private and non-profit subsidized housing will be influenced by the form rent regulation takes. If regulation continues to be restrictive or is so regarded by investors, the availability problem will remain acute for moderate and low-income households. The problem will tend to affect middle and upper income households as well under a policy which allows no exemption from regulation. The need for government funding for new and replacement rental housing will increase. If, however, regulation is moderated with a view to restoring fair market level rents, there would be a reasonable expectation of renewed private investment. This should eventually make it unnecessary for government to subsidize the production of rental housing for households which can pay fair market rents. Even if this happens, the public sector will continue to make rental housing available to low-income households on a rent-geared-to-income basis.

The lack of available rental housing can be alleviated in other ways. Government programs which encourage and assist the move from rental to home ownership free up rental housing. Simplifying and accelerating construction and regulatory processes will contribute to an earlier delivery of housing supply. Institutional programs imposing maintenance and conservation requirements will help to keep the supply of habitable housing from being depleted.

4.9 Decline in Maintenance and Conservation

In an unregulated market, which allows landlords to charge fair market rent, there would normally be no incentive for landlords to reduce maintenance and conservation expenditures. However, when rent increases are restricted and, as is now the case, many buildings have waiting lists of potential tenants, the incentive to maintain traditional standards is diminished. Landlords know that if one person refuses the apartment, there are many others who will not. Furthermore, reducing maintenance can enable landlords to realize more cash out of their buildings than they otherwise would.[101]

101. Note, however, that the capital value of the building may be reduced. In the event that regulation is made less restrictive at a later date, the building will command lower rents, if it is poorly maintained. To elevate maintenance at a later date could be costly. These considera-

This problem is distinct from the problem of substandard housing addressed in section 4.6. Even with a reduced level of maintenance, most buildings will satisfy legislated standards of health and safety. This problem addresses the concern that a general deterioration of the premises, which means tenants are getting less value for their rent payments, circumvents the regulatory system by achieving what amounts to a rent increase. The reduction of maintenance is equivalent to a rent increase in that the landlord's profits are increased and the tenant pays more, relative to the value of services received.

Clause 131(1)(c) of the 1979 Act is intended to block this method of circumventing rent regulation by including in rent increase determinations:

> . . . the findings of the Commission concerning an improvement or deterioration in the standard of maintenance and repair of the residential complex or any rental unit located therein.

Both the 1975 Act and the 1979 Act empowered review officers to order a rent reduction and gave tenants the right to dispute a guideline increase where there had been such a deterioration. Those provisions have been carried into the 1986 Act although not in quite the same words.

This approach to the problem of declining maintenance requires a subjective finding regarding the change in the level of maintenance in a building, but no criterion have been established for making such findings on a consistent basis. Furthermore, the approach is not consistent with the general principles of cost pass-through. Within the context of a cost pass-through system, it is more appropriate to pass-through the cost savings associated with a reduction in maintenance expenditures than to adjust the rent increase on the basis of a subjective evaluation of the appearance of a building or the landlord's method of maintenance.

The topic of maintenance is discussed at some length in section 9.7 of Volume 1 of this Report. The comment is made there that if a reduction in the amount spent on maintenance and repair occurs, the amount of the rent increase which would be justified is taken into account automatically by a whole building review. To impose additional penalties will be counter-productive in that it may make it more difficult for the landlord to afford to maintain the building.

The response of the current regulatory system also is deficient in that it cannot deal with a slow-paced, general decline in maintenance and conservation which may not become apparent for a number of years. It is evident if rent

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tions have served to discourage many landlords from letting their buildings get too badly run down.

regulation is to be continued in Ontario, new means must be found to stop deliberate reductions in maintenance and conservation expenditures.

4.9.1 Policies To Maintain Standards of Maintenance and Repair

It is evident that the problem of reduced maintenance and conservation is a direct consequence of restrictive rent regulation. The most effective way to eliminate this problem is to regulate with a moderate rather than a restrictive regulatory system. With moderate regulation, the problem of availability of supply could be resolved over time. With increased vacancy rates the need for landlords to maintain their buildings in order to attract tenants would again be evident; hence, the incentive to cutting maintenance would be eliminated.

Nevertheless, whatever approach to regulation is used, maintenance could continue to be a controversial issue unless a procedure is developed for classifying buildings on the basis of their standard of maintenance. For example a checklist could be developed which could be used to "score" buildings on a 10-point scale. The score of a building could be used to determine changes in its standard of maintenance over the years, or to compare different buildings. This concept is adopted in Chapter 5 as part of the FMR system.

Although budgetary or institutional policies could be used to improve maintenance standards, the Inquiry sees no need to undertake those forms of intervention — provided tenants can be reasonably assured of getting what they pay for either through market forces or a regulatory system which ensures that similar rents are paid for units of similar value, taking into account maintenance standards of buildings.

4.10 Public Policy Concerns

The problems of rental housing are matters of concern not only to landlords and tenants. An industry which directly involves about a third of the population, with capital investment and cash flow putting it among the leaders in the business life of the community, has wide ranging social and economic impacts. While the Inquiry's mandate is not to examine and comment upon every aspect of rental housing, this brief section touches on some concerns which have arisen during the course of the Inquiry which, while not related directly to the operation of the rental housing market or rent regulation, were regarded by participants as important, related social concerns.

Section 4.10.1 discusses the issue of preservation of neighborhoods, which is a broad social or lifestyle issue. Section 4.10.2 identifies concerns related to the redistribution of income which appears to be an issue that implicitly colors the views of many regarding rent regulation. Section 4.10.3 addresses concerns about government budgetary constraints, a factor which must be kept in mind when any policy question is reviewed.

4.10.1 Preservation of Neighborhoods

When controls were enacted in Ontario in 1975, preservation of neighborhoods' social and economic characteristics was not mentioned as an objective of rent regulation. It was, however, specifically advanced as an objective of rent regulation in the course of the Inquiry's hearings.

The quality of urban life is a matter of intense interest to the inhabitants. If the local community feels content with the area's social and economic aspects, it is natural that they and their elected representatives will be anxious to maintain the status quo.

The representation was made to the Inquiry that because regulation holds down rents the residents will be inclined to stay where they are. That being so, vacancies would not occur which would allow the entry of incompatible newcomers and there would be resistance to selling to allow redevelopment and the introduction of non-residential uses. The Inquiry recognizes the desire on the part of a neighborhood to preserve its agreeable characteristics but doubts that restrictive regulation in the long run will be enough to restrain the pressures for change in a dynamic urban context. There are many factors which determine the character of a neighborhood and its susceptibility to change. They can be countered more directly for a period of time by institutional policies controlling conversion, demolition and land use. Also, budgetary policies offering financial assistance to landlords to meet the cost of renovating and conserving existing stock will serve to maintain the physical quality of the housing stock and hence contribute to residential stability.

4.10.2 Redistribution of Income

Redistribution of income is a socio-economic process of taking from those who have more to give to those who have less. The progressive income tax and the social programs financed by tax proceeds are classic examples of income redistribution. There are some who say that rent regulation should have a redistributive effect by holding rents below the levels they might otherwise reach. This approach to regulation assumes that all landlords are rich or well-to-do and all tenants are poor when, in fact, any study of the market will reveal that this is not the case. Hulchanski (1984) has this to say:

> Another common misconception about the rationale for rent regulations is the belief that they are intended to achieve the redistribution of income. . . . By most standards rent regulations would be a blunt and unfair tool for achieving a redistribution of income in society. Rent regulations arbitrarily assist all tenants covered by regulations no matter what their incomes. Moreover rent regulations designed to accomplish redistribution of income would operate at

> the expense of one class of citizens, the owners of rental accommodation. (p. 83)

Hulchanski does make the point that rent regulation serves to prevent regressive redistribution of income which would occur if landlords were charging excess rent and making excess profits.

Fallis (1984) also discusses the relationship between rent regulation and the redistribution of income. (p. 46) His approach is from the social value that the distribution of income in the community should be fair and equitable but he concludes that rent regulation is not a preferred substitute for the progressive income tax and other forms of income redistribution such as the old age pension, free education and health care. He suggests, however, that a case can be made for rent regulation redistributing windfall gains and abnormal profits or when the landlord seeks excessive rent increases. In the latter regard he says, "a government program to deal with specific allegations would be far better than a blanket policy like regulation." (p. 52)

4.10.3 Budgetary Constraints

The policies and programs referred to as budgetary in this Report are so called because they involve the expenditure of government funds. The term was introduced by Chant (1986, p. 441) to whose study attention is directed. They include direct expenditures as well as tax expenditures, that is to say foregone revenues through tax incentives such as the MURB program. Government planning for rental housing policies must take into consideration both the efficacy of a prospective program and its cost to the public and to the participants in the market. The decision by government to adopt a budgetary policy and the amount of funds to devote to it, or to terminate a policy already in place, will be affected by many considerations: the state of the economy and of government finances; the ripple effect on business and industry; its political appeal; economic efficiency; and the prospective benefical results. The only comment the Inquiry can offer is that a problem requiring a budgetary response — for example, the affordability problem of low-income households — can only be acted upon if the government is able to finance the cost of the program through taxes or borrowing. If the government is not prepared to finance the budgetary programs needed to achieve a social objective, such as reducing the affordability problems of low-income households, it is not justifiable to impose a program such as restrictive rent regulation which lays the burden of providing assistance on one group within society — the landlords. Using non-budgetary measures may hide the cost of the program, but it does not mean that the benefits have been obtained at no cost to society. The cost is there and landlords

realize it, which is why investors are wary of investing in rental housing if they will be subject to restrictive regulation of the rents they can charge.

4.11 Concluding Comments

This Chapter examines a number of problems which motivate rental housing policies and programs. All have been claimed at one time or another to be reasons for rent regulation. However, the analysis finds that rent regulation alone cannot respond effectively to all the problems simultaneously. It is necessary to narrow the objectives of rent regulation and use other means to resolve those problems for which rent regulation is unsuited.

Rent regulation does one thing only, it limits the rent landlords may charge for their units. Fair market rent is the only rent which is fair for both tenants and landlords. Furthermore, holding rents below the fair market rent level is not compatible with maintaining a viable private sector in the rental housing industry.

Consequently, the objective of rent regulation should be to set rents which are fair market rents. Doing so will resolve six of the problems identified in this Chapter:

— excessive rent charges:

— a high rent level on an on-going basis as indicated by excess industry profits;

— rapid increases in rents due to changing rental housing market conditions;

— the availability of capital;

— the availability of rental housing; and

— reduced maintenance and conservation.

Excessive rent charges are isolated cases of landlords charging more than the fair market rent for a unit although rents generally are not excessive. Excessive rent charges include both cases where the tenant pays a high rent rather than suffer the dislocation of a move to a fairly priced unit — referred to as gouging — and cases where the tenant is force to leave because he cannot pay the excessive rent charge — referred to as economic eviction. A rent regulation system which restricts the ability of landlords to charge more than the fair market rent would resolve the problem of excessive rent charges.

Excess industry profits refers to the situation in which the industry in general is able to charge rents on an on-going basis above the fair market level. Hence, the industry return would be above the competitive rate of return in

the long-run. There is a perception among many tenants that landlords earn excess profits despite the conclusion drawn from economic analysis that excess profits are not sustainable. Adequate data to empirically prove or disprove the point are not currently available. A system of rent regulation which sets rents at the fair market level would eliminate excess profits, if they are a real problem. The system would leave rents at the same average level as would be obtained in an unregulated market where supply balances demand if excess profits, in fact, are not a problem.

Rapid increases in rents due to changing rental housing market conditions are a problem related to short-term imbalances between supply and demand. The tenant's concern is that when vacancy rates are low, landlords are able to raise rents unduly. The result may be rents which exceed fair market rents in the short run — that is, until new supply brings the market back into balance. A system of rent regulation which sets rents that are fair market rents would resolve this problem.

The problems of availability of capital, availability of rental housing and reduced maintenance and conservation are problems which differ from the other problems identified in this Chapter. They are not problems of the market but are problems caused by restrictive regulation. They are related to each other in that each arises when rent regulation holds the return on investment in rental housing below the competitive rate of return. When that situation occurs, investors take their money elsewhere. As a result, there is a shortage of private sector capital in the industry generally. The shortage of capital results in an inadequate supply of private sector rental housing and reduced maintenance and conservation. These problems would not occur if investors anticipate earning a fair return on their investment in rental housing. Hence, a moderate rent regulation system which sets rents that are fair market rents would avoid those problems, provided the permanence of the system is well enough established that investors believe it will permit them to earn a fair return over the period of their investments.

This Chapter identifies three problems for which rent regulation is not an appropriate response. They are:

— the affordability of rental housing;

— insecurity of tenure; and

— substandard housing.

Affordability of rental housing is a problem which affects most low-income tenants and some middle-income tenants, although to a lesser degree. The problem is simply the financial inability of tenant households to afford the rent required to provide them decent, adequate housing suitable to their

needs. Housing is just one of the basic necessities of life and tenants who do not have the income to pay market rents will have difficulty in meeting other necessary outlays as well. Essentially the problem for tenants in that situation is an income rather than a rental housing problem and should be dealt with as such.

Rent regulation is not an appropriate way of dealing with the affordability problem of tenant households, because it could only do so by reducing the rents low-income households pay to their socially fair rent limit and the private market could not function on that basis. The only effective approach to resolving affordability problems is to commit the necessary public funds to provide budgetary programs which assist the low-income households. To treat all households which qualify for assistance equitably would require a shelter allowance program to supplement socially assisted housing programs by subsidizing renters for whom suitable socially assisted housing is not available.

The problem of insecure tenure is a matter of great concern to tenants and can arise for several reasons. Where a landlord seeks to evict the tenant without just cause, tenure can only be protected by institutional policies. The Landlord and Tenant Act provides this protection at the present time. The phrase has been expanded to include economic threats to security of tenure which can be normal rent increases or even by a static rent level if the income of the tenant household is depressed or does not keep pace with rent increases. In that situation the problem, referred to as economic insecurity, is an affordability problem and should be dealt with as one. Security of tenure can also be threatned by excessive rent increases, that is gouging and economic eviction, which as already noted can be resolved by rent regulation.

Substandard housing is the final problem not dealt with by moderate rent regulation. It is a persistent feature of a small segment of the rental housing market and is of great concern to low-income tenants. It can be dealt with most effectively by the enforcement of housing standards through the application of legal sanctions. To use a regulatory scheme to enforce housing standards would create problems in ensuring that due process is observed before sanctions are imposed and would compromise the integrity of the regulatory process. Rent regulation is not suited to the enforcement of housing standards.

Chapter 5

The Fair Market Rent System of Rent Regulation

Chapter 3 reviewed different approaches to rent regulation. With that as background, the Inquiry has designed a system of rent regulation which, in its opinion, has the best prospect of achieving the objectives of rent regulation as outlined in the concluding comments of Chapter 4. Referred to as the Fair Market Rent (FMR) system, it combines a type of rent control to govern the overall rate of increase in rents with a procedure for reviewing the rents of individual units.

The Chapter begins with a discussion of design considerations in section 5.1. This section includes a brief overview of the FMR system. Section 5.2 describes the procedure for determining the rent control guideline rate, called fair return rent control. The other arm of the regulatory system, called market comparison rent review, is described in section 5.3. Section 5.4 describes a mechanism for single building rent review. Sections 5.5 and 5.6 comment on two further aspects of the FMR system, negotiation and the FMR rent registry. Sections 5.7 and 5.8 describe how the FMR system would deal with two particular problems: claims for illegal rents which predate the FMR system and rents for post-1975 buildings. Section 5.9 discusses the similarities and differences between the FMR system and the current Ontario system under the 1986 Act. Concluding comments are made in section 5.10.

5.1 Design Considerations

The concepts of fair return and fair market rent were examined in Chapter 2. Since the unregulated market cannot ensure fair market rents at all times, the Inquiry believes a regulatory restraint of some nature is required to deal with the possible problems of: 1. landlords earning excess profits, indicating rents are higher than they should be; 2. the unregulated market permitting excessive

rent charges in the form of gouging and economic eviction; and 3. sharp, unexpected increases in local rent levels occurring under certain market conditions, which are prejudicial to tenants.[1]

As a result of the restrictive rent regulation system which has prevailed in Ontario for almost 12 years, many rents have been held below the fair market level and fairness to landlords requires this be corrected. The intent of the Fair Market Rent system proposed in this Chapter is, as its name implies, to assist both tenants and landlords by restoring rents to fair market levels and controlling the market forces which could drive rents above that level.

The directives in the Order in Council would not be met if the Inquiry did not propose a system of rent regulation which provides for the fair and equitable treatment of all landlords and all tenants. The Inquiry believes the FMR system of rent regulation would satisfy that fairness requirement. In addition to fulfilling the societal requirement of fairness, the FMR system also responds to the economic reality that fair market rent must serve as the basis for Ontario's system of rent regulation.

Historically, participants in the private sector have played the leading role in the rental housing industry both as landlords and as investors providing funds for new construction, to replace losses through demolition and conversion, and to conserve the existing stock. It is evident that if the housing needs of Ontario's renters are to be met in the future, the private sector must continue to play an important role as providers of rental housing. The point has been made elsewhere in this Report however, that without subsidies the private market is not capable of supplying the housing needs of the whole tenant population. Specifically, it cannot meet the needs of households too poor to pay the fair market rent for adequate housing. Responsibility for assisting such households lies with government. Government, however, should not supply housing for those households financially able to pay market rents — except perhaps as a short term measure to remedy exceptional market conditions. The current inadequate supply, attributable in large measure to a restrictive system of rent regulation, is such a condition. The housing requirements of low-income tenants will be an on-going problem, the costs of which must be met and shared by the whole community. The costs of public and other forms of socially assisted, non-profit and co-operative housing are substantial and given other spending demands on government, strain the fiscal capacity of Ontario. The Inquiry supports the principle that — except in special circumstances and for special purposes — the costs of supplying and maintaining the stock of rental housing should remain in the hands of the private sector.

1. The trade-offs between the imperfections of the market and the imperfections of regulation are considered in section 6.2.

For the rental housing market to be attractive to private investors, they must anticipate earning a return on investment comparable to the return possible through other investments with similar risk. If regulation reduces rents to the point where landlords cannot expect to earn a competitive return, they will not invest. There is no justification for reducing the income from privately financed rental housing unless excessive profits are being earned. To translate that into the terminology of Chapter 3, (see section 3.1.1), it is evident that private sector investment in rental housing will be attracted to the industry only if landlords are allowed a competitive rate of return and only if the regulatory system is moderate rather than restrictive.

A moderate system of rent regulation must be responsive to changing economic conditions or it runs the risk of inadvertently becoming restrictive. Conversely, it serves no purpose to design a restrictive system that in reality will function as a moderate system due to poor enforcement or generous loopholes. Lax enforcement and loopholes may encourage some investors but people adept at exploiting the weaknesses of a system are not likely to be of service to Ontario's rental housing industry. Furthermore, the consequences of lax enforcement would be uneven through the market and inequities would be frequent. The FMR system described in this Chapter is designed explicitly to be moderate so that it can be strictly enforced and consistently applied without discouraging investment in rental housing.

It also must be recognized that investing in rental housing is like investing in any other business — what investors earn will depend, among other matters, on how their business is managed. Buildings with excessively high operating or financing costs will be less profitable than buildings with lower costs. Under the FMR system, landlords with higher costs will have to absorb the excesses since the rents for comparable units will be similar. If they attempt to raise rents above the general market level they will suffer unacceptably high vacancy costs. Conversely, landlords with relatively low costs will have higher than average returns. In setting rents on the basis of similar rent for similar units, the FMR system provides an incentive for landlords to keep their property attractive to tenants while keeping costs as low as possible.

A further consideration for private investors is their expectations regarding possible changes to the regulatory system — expectations strongly influenced by the history of rent regulation. Governments cannot force private investors to invest in rental housing when the opportunity is not attractive; however, they can significantly alter the attractiveness of rental housing investment, either positively or negatively. If government has a record of changing the regulatory scheme to make it more restrictive, investors will fear that trend may continue and will not invest in the rental housing market unless there are benefits such as government subsidies or higher expected rents to compensate

adequately for the political risks threatening the future profitability of their investment.

The FMR system of rent regulation is designed with the foregoing considerations in mind. Its aim is to allow the industry a fair but not excess return on investment and to adjust rents when rents for similar units differ significantly. To this end, rents would return to — but not exceed — the fair market level. The result will be fairness to landlords and to tenants. The FMR system is not a short-term policy to deal with abnormal or temporary market conditions. It is designed to serve as a long-term regulatory device which acknowledges the necessity for the ongoing viability of the private rental housing market in Ontario.

5.1.1 Overview of the FMR System

Chart 1 sets out the three components of the FMR system: fair return rent control (guideline rate), market comparison rent review, and single building rent review. For each component, the relevant criterion of fairness, the problems it addresses, and the organization responsible for its administration is indicated. Chart 2 shows the overall organizational structure of the system and provides a summary of the responsibilities of each of its components. They would be co-ordinated by a working committee of the senior personnel from the Guideline Board, the Rent Review Commission and the administration of the Rent Registry. This committee would have no staff of its own and would meet periodically to handle coordination problems and to deal with such matters as the overall budget of the system and its annual report to the government.

The responsibilities listed under each arm of the Rent Commission relate to the mechanics of the system as described in the rest of this Chapter.

Returning to Chart 1, it can be seen that the Guideline Board is responsible for the fair return rent control component of the FMR system. Its primary job is to determine the annual guideline rate, based on analysis of the financial data of landlords. Fair return rent control is required to ensure that the industry's profit is adequate but not excessive; that is, the general level of rents is at the fair market rent level. In doing so, it responds to five of the problems identified in Chapter 4.

Chart 1 also shows that the Rent Review Commission is responsible for market comparison rent review and single building rent review. Those components of the FMR system address fairness in terms of the relative rents of particular units, rather than the overall level of rents. Market comparison rent review is used to adjust rents so that the rents for units reviewed reflect the average rent for similar units in other buildings. Single building rent review also ensures that similar rents are charged for similar units, but its scope is restricted to units within a building. Single building rent review, as distinct

Chart 1: The Fair Market Rent System

Component of the FMR System	Fair Return Rent Control (Guideline Rate)	Market Comparison Rent Review	Single Building Rent Review
Criteria of Fairness	Fair Market Rent Level –industry profit is adequate but not excessive	Between Building Fair Market Rents –rents for similar units in different buildings are similar	Within Buildings Fair Market Rents –rents for similar units within a building are similar
Problems(s) Addressed	–excess profits (4.3) –high rents due to temporary market conditions (4.4) –availability of capital (4.7) –reduced maintenance and conservation (4.9)	–excessive rent charges in a building generally (gouging and economic eviction) (4.2)	–excessive rent charges for a unit or a few units in a building (gouging and economic eviction) (4.2)
Organization[1] Responsibility	Guideline Board	Rent Review Commission (Review Officers)	Rent Review Commission (Review Officers)

NOTE: Numbers in brackets refer to the section of the Report which discusses each problem.

The Fair Market Rent System is not designed to deal with three of the problems identified in Chapter 4: affordability (section 4.1), insecurity of tenure (section 4.5) and substandard housing (section 4.6). Affordability can only be adequately dealt with by means of budgetary policies. Security of tenure, aside from threats arising from other problems dealt with by the FMR system, is adequately dealt with by the current provisions of the Landlord and Tenant Act. Substandard housing can only be dealt with by means of institutional policies, possibly augmented by budgetary policies.

Chart 2: Organizational Structure and Responsibilities Under the FMR System

Guideline Board (Autonomous)

–Conduct annual hearing

–Determine
  –guideline
  –variances

Staff of the Guideline Board

–Data collection

–Data analysis

–Recommendations to Guideline Board
  –guideline
  –variances

Rent Review Commission (Rent Review Officers) (Autonomous)

–Conduct hearings
  –market comparison rent review
  –single building rent review

–Issue orders pursuant to hearings

–Process orders to rent registry

–Operate on a decentralized basis

Staff of the Rent Review Commission

–Prepare information on comparable buildings for market comparison rent review hearings

–Prepare information on rents of buildings for single building review hearings

Rent Registry Administration (Government Agency)

–Maintain data base
  –registered rent
  –actual rent
  –unit size

–Adjust registered rent data annually to reflect
  –guideline
  –review hearing orders

–Update actual rent data annually
  –issue rent roll forms to
  –process returns

–Follow-up where tenants allege rents are illegal

from market comparison rent review, is necessary only to provide a less cumbersome procedure than market comparison rent review to deal with alleged causes of gouging and economic eviction and other issues that relate only to the relative rents being charged within a building.

5.2 Fair Return Rent Control

The purpose of the FMR rent control guideline rate is to control the level of rent increases generally to allow the industry a competitive — but not an excess — rate of return on investment. If fair return rent control is to perform that specific function, the difference between the actual level of rents and the fair market rent level must be determined as accurately as possible. Furthermore, the manner in which it is done must gain the confidence of both investors and tenants so that the resulting rent control guideline will be seen as fair by both sides. The best way to achieve fairness and to be seen by all parties to be achieving fairness is to determine the guideline rate of increase by using actual industry data which are examined in public hearings. The procedure to be followed in that regard is described below.

5.2.1 Guideline Board

A Guideline Board would be established to be responsible for setting the fair return guideline rate on an annual basis. The decision of the Guideline Board would be based on: 1. data collected by the staff of the Board; 2. staff calculations of the actual rent level and the fair market rent level; and 3. the submissions of tenant and landlord representatives. Revenue and cost data for the industry would be obtained by means of a survey of the business records of a statistically significant sample of landlords.[2] The information required from each landlord surveyed would be similar to that of a cost-revenue statement but would include more extensive financial information as well as asset value information. The data for the operations of each surveyed landlord would be collected and analyzed by trained personnel.[3] Since the information would be collected to form a data base and not to set rents in individual buildings, separate hearings for each landlord would not be required. Cost, revenue and financing data for the previous year would be collected so that statistically

2. Many landlords own and operate several complexes as one business entity. The data required for the survey is with regard to a landlord's rental operation — which might be anything from a simple unit to a multi-building business entity.

3. In recent years, there have been between 1,400 and 4,200 whole building review decisions annually, accounting for five to 15 per cent of all rental units. Something at the lower end of that range would constitute a data base for the fair return rent control system which would provide acceptable estimates of industry costs in terms of their statistical signficance.

valid determinations of the actual rent level and the fair market rent level in that year can be made. Additional historical data covering two or three earlier years also could be collected to assist in projecting future cost increases. However, there are alternative ways to project cost increases which would be satisfactorily accurate and would require less effort.

The Staff of the Guideline Board would prepare estimates of industry revenues, industry costs and the required rate of return, based on the data collected.[4] Their findings and a recommended guideline rate for the coming year would be presented to the Guideline Board at a public hearing. Parties representing tenant and landlord groups would be invited to make representations concerning any aspect of the determination of the guideline rate, including the data collection and analysis procedures. The hearing would operate much like the rate hearings held by the Canadian Radio-television and Telecommunications Commission (CRTC), the Canadian Transportation Commission, (CTC) and other regulatory bodies which set prices in other industries.[5]

5.2.2 Components of the Fair Return Guideline Rate

To determine the increase in rents necessary for the industry to earn a fair return but no more, the fair return guideline rate would combine two components:

1. the percentage by which the current rent level falls short of, or exceeds, the current fair market rent level, and

2. the percentage by which all economic costs[6] and hence the fair market rent level, are estimated to change over the next year.[7]

4. A wealth of experience is available to be drawn on for purposes of preparing technical guidelines for determining landlords' costs. The Residential Tenancy Commission is experienced in determining the annual operating and debt costs which can be properly attributed to the operation of a residential rental property in a variety of unusual circumstances such as where there is a mixed use of the building or where there is unusual financing of the building. Other regulatory bodies which utilize the rate base-rate of return method of regulation have expertise in determining the appropriate rate base and required rate of return for purposes of calculating the allowed equity component of the industry's total allowed costs. For more detailed information on Canadian experiences with rate base-rate of return see H.N. Tanisch, et al. *The Regulatory Process of the Canadian Transport Commission* (1978) and C.C. Johnston. *The Canadian Radio-television and Telecommunications Commission* (1980). Both were published by the Law Reform Commission of Canada.

5. An important difference would be that regulatory staff would prepare and present the cost and revenue information rather than the industry as is the case in rate setting hearings. That shift of responsibility is needed to maintain the integrity of the regulatory system since costs and revenues are to be determined on a statistical basis.

6. Economic costs include operating costs, debt interest and the required return on equity.

Chart 3 illustrates the calculation of the fair return guideline rate. The current actual rent level and the current fair market rent level are based on the most recent landlord data collected by the Staff of the Guideline Board. The top illustration shows the case where the current actual rent level is below the current fair market rent level and the bottom illustration shows the case where the current actual rent level is higher. In either case, the allowed rent increase for the industry (the guideline rate) is the sum of the increase in the projected fair market rent level and the gap between the current fair market and actual rent levels.

During a transitional period following the introduction of the system, the first component would be a positive value as current actual rent levels are brought up to the fair market level as determined by the Guideline Board. In the case of a large divergence, the adjustment could be phased in by adding to the guideline rate only a fraction of the first component. That treatment would be analogous to the treatment of a landlord's financial loss in the current rent review process as set out in subsection 79(3) of the 1986 Act (formerly section 3 of the 1982 Act). Although phasing in a large adjustment would delay the ultimate adjustment to the fair market rent level, it would avoid sudden sharp rent increases and smooth the rate of change in market rents. After the transitional period the first component could be either a positive or negative value. The second component — the expected rate of change in economic costs and hence, the fair market rent level — would be a positive value so long as inflation is the normal feature of the economy. Applying the fair return guideline rate to the actual current rent would allow rents to rise sufficiently for the industry to earn a fair return on average.

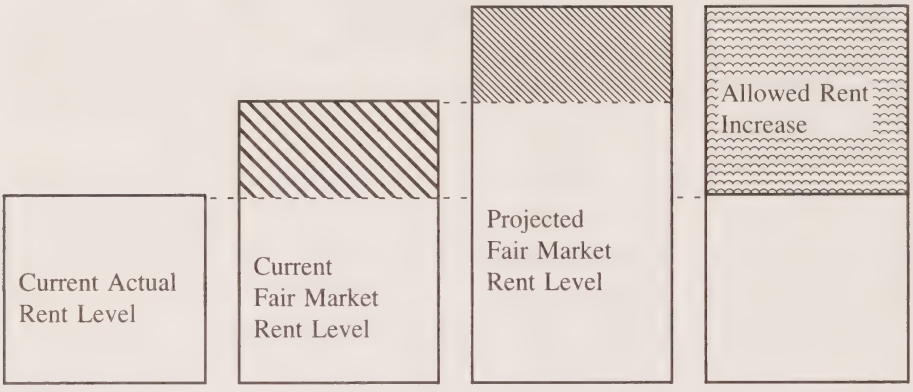
The first component of the guideline rate — the difference between the current actual rent level and current fair market rent level — would be determined using the data collected by the Staff of the Guideline Board. The Staff would have to calculate the required total revenue of the industry which would be sufficient to cover all operating and debt costs and provide the competitive rate of return on the industry's total equity. The rate base-rate of return approach discussed in section 4.1.3.2 above would be used since it is the only approach which takes into account all of the relevant costs. It can be used to determine the total revenue required by the industry for it to have earned a fair return in

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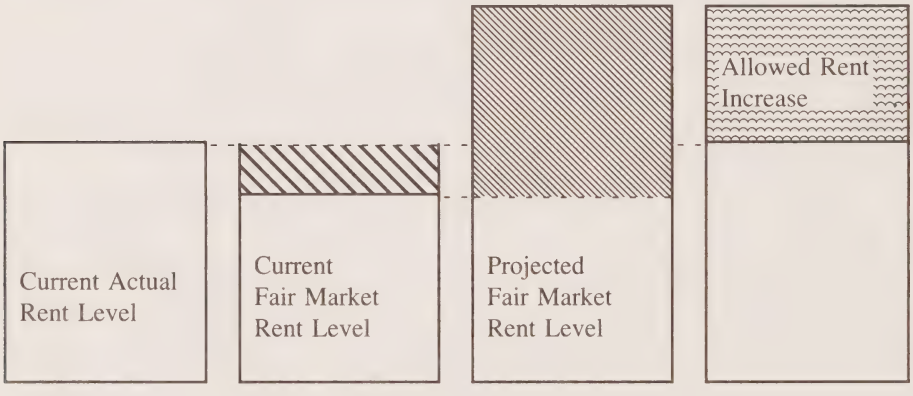
7. Mathematically, the fair return guideline rate should be:
$i = (1+j)(1+k) - 1$
where:
i is the fair return guideline rate
j is the fraction by which the current fair market rent level exceeds the actual rent level
k is the fraction by which the fair market rent level in the next year is expected to exceed the current rent level

Chart 3: Calculation of the Fair Return Guideline Rate

1. Assuming landlord costs are increasing, actual rents are below the fair market rent level and no phase-in.



2. Assuming land costs are increasing, actual rents are above the fair market rent level and no phase-in.



Legend

—Increase (decrease) required in the current actual rent level to adjust it to the fair market level.

—Increase in the fair market rent level from the current year to the projected year.

—Total rent increase which would be allowed in order to increase the current actual rent level to the projected fair market rent level, with no phase-in.

the most recent year for which data are available. The industry-wide rent increase or decrease required to adjust the current rent level to the fair market level would be the percentage difference between the actual total revenue of the industry and the required total revenue.

The second component of the fair return guideline rate, the rate of increase in fair market rent, would be based on projected changes in operating costs and the cost of capital. The cost of capital can be computed from average mortgage rates, the required return on equity for investment in rental housing and the allowed capital base. Since it is difficult to predict future cost increases, the estimated increase in the fair market rent could be based on previous years' increases. For example, a weighted average of the rate of increase for the previous three years could be used. Alternatively, it could be tied to the projected rate of inflation based on an econometric model of the economy or the forecasts of suitable experts. Whatever the basis for the estimated increase in the fair market rent, parties to the annual rent review guideline hearing would be permitted to make submissions and the Guideline Board would determine what it considers to be the best estimate of the expected rate of increase in the fair market rent.

Errors in predicting the rate of increase in the fair market rent level for any year would be corrected by the first component of the guideline rate in the following year. As a consequence, errors in the guideline rate would not accumulate over the years as they can with a system such as that currently in place in Ontario. Without that mechanism for compensating for guideline rates which are too high or low, it would be difficult if not impossible to have a long-term system of rent regulation which could keep the actual rent level reasonably close to the fair market rent level.

5.2.3 Calculation of the Fair Return Guideline Rate

It is evident from Chart 3 that in order to calculate the fair return guideline rate, it is necessary to determine on a consistent basis:

1. the actual rent level for the current year,
2. the fair market rent level for the current year, and
3. the estimated fair market rent level for the next year.

In practice, the most recent year for which data are available would be used as the current year.

Consistency is achieved by using the same set of buildings for each calculation. It is important to remember that fair market rent would not be

determined on an individual building basis, but only on an aggregate basis from the sample of landlords' buildings surveyed.

The "current year" refers to the most recent year for which actual financial data on the buildings are available. For example, the "current year" could be the 1987 calendar year for a hearing held in mid-1988 to establish the fair return guideline rate to take effect January 1, 1989. If that were the case, the "fair market rent level for the current year" would refer to the 1987 fair market rent level and the "estimated fair market rent level for the next year" would refer to the 1989 fair market rent level. As a consequence, the component of the fair return guideline rate representing the increase in the fair market rent level would reflect the increase over the two-year period.[8]

Before considering how each of the three items would be calculated, the purpose behind the calculations should be fully understood. For people to be willing to invest, the amount of money they spend must be balanced by the amount they receive. If more money is spent by investors than they receive in the same year, in a later year they must receive more than they spend as compensation for the previous shortfall. The surplus amount they receive in the later year must equal the shortfall *plus* compensation for leaving their funds invested in the industry for a period of time. The additional compensation required is determined by the required, i.e. competitive, rate of return. In determining the annual cash flow it is necessary to consider all outlays including the initial investment in the building and all receipts, including both rental income and the net proceeds received when the property is ultimately sold.

5.2.3.1 The Current Actual Rent Level

The current actual rent level would be the aggregate gross rental income in the current year for all residential complexes owned by the landlords surveyed. As noted above, the current year is the most recent year for which actual data are available. The gross rental income figure could be converted into an average rent per unit, or an index;[9] doing so will not affect the value of the components of the fair return guideline rate. The current and estimated fair market rent levels must be calculated on a consistent basis, whether it is on the aggregate industry basis, a per unit basis or on the basis of an index relative to the base year actual rental income.

8. Hence, the 1989 guideline rate would equal the percentage difference between the fair market and actual rent levels in 1987, plus the total estimated increase in the fair market rent level from 1987 to 1989, minus the 1988 guideline rate.

9. For example, an index similar to a price index such as the Consumer Price Index could be established by dividing current actual rental income by a base year actual rental income and multiplying that ratio by 100.

5.2.3.2 The Current Fair Market Rent Level

The current fair market rent level is a more complex calculation but it too would be based on the historical financial data from the sample of landlords surveyed. Essentially, it would be an amount equal to the aggregate landlords' costs including operating costs, investment in the property, capital value effects and tax effects.

Chart 4 illustrates the calculation. Essentially, the landlords' financial benefits must equal their financial costs. The financial benefits are: 1. rental income, 2. tax benefits and 3. increases in the capital value of the property. Financial costs are: 1. operating costs and 2. the cost of capital. The cost of capital can be further broken down into the cost of debt and the cost of equity as shown.

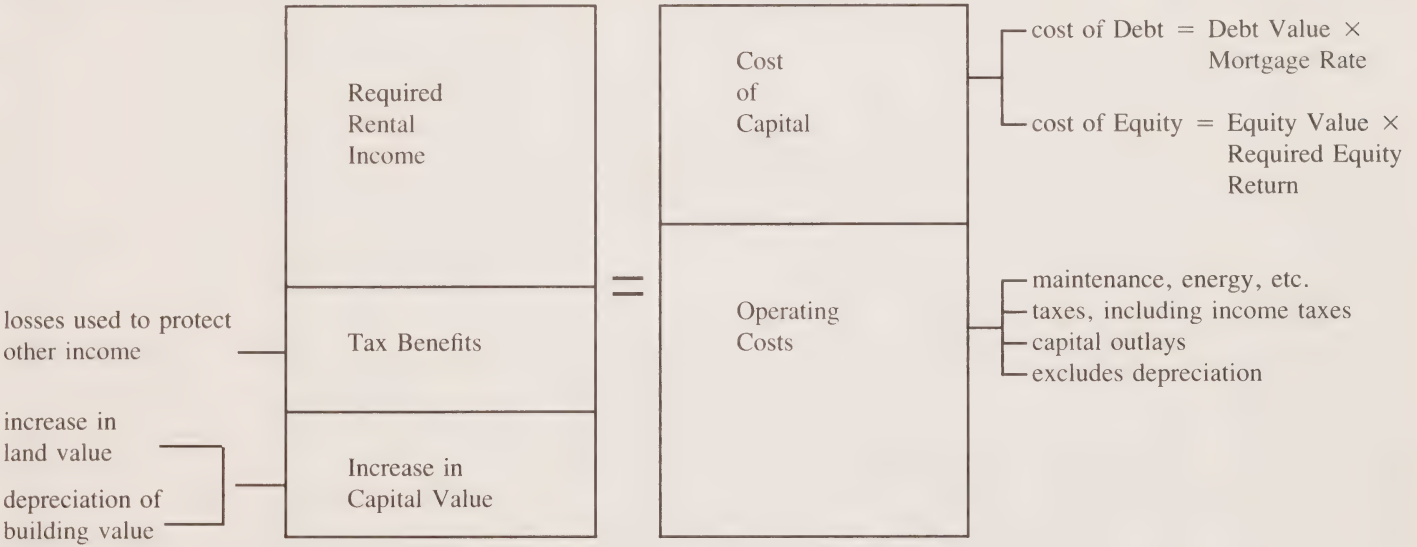
The required rental income is the actual rental income required so that the landlords' financial benefits will equal their financial costs. The current fair market rent level is the general rent level, relative to the current actual rent level, which would provide landlords overall with the required rental income. The projected fair market rent level (see Chart 3) is the level of rents in the projected year, relative to level of rents in the current year, needed to provide the required rental income in the projected year, given the expected cost of capital, operating costs, tax benefits and increase in capital value in that year. A more detailed discussion of each element entering the calculation is provided below.

In this Chapter several references are made to the rate base-rate of return regulatory system presented by Quirin (1986). The primary difference on the conceptual level between the FMR system and the Quirin system is that the former determines the fair rent level on an industry-wide basis, whereas the Quirin system does it on an individual landlord basis. On the implementation level, there are significant differences between the FMR and Quirin systems. Although each divides costs into four components, only two, operating costs and tax effects are the same. Quirin (1986, p. 263-267) has two other components: debt service and equity return. The debt service component includes a depreciation allowance and no consideration is given to changes in the equity value of the property. The return on investment component of the FMR calculation would combine both Quirin's debt service and equity return components but would make no allowance for depreciation. The FMR's capital value effects component would take into account depreciation and all other factors which affect the capital value of the property.

Operating Costs

Operating costs would include all the landlords' outlays other than the initial purchase price of their buildings. It would not be necessary to distinguish

Chart 4: Calculation of the Fair Market Rent Level



NOTES: 1. Debt Value plus Equity Value = Current Property Value. 2. All calculations are made on an aggregate industry (survey sample) basis

between capital expenditures, other than the initial cost of developing the property, and other operating costs since a cash flow perspective would be used.[10]

Return on Investment in the Rental Property

The only outlay investors incur in addition to operating costs is the initial investment to develop the rental properties. That investment has a capital value which will change from year to year and may either increase or decrease over the lifetime of the building.[11] This amount would not be treated as an outlay which would be recovered as part of the rental income. Rather it would be treated as an on-going capital investment. Investors would receive a return on that capital which is part of the calculated fair market rent, allowing them to receive the required rate of return on the funds invested. The return on total capital covers both mortgage interest and the return on the landlords equity. The allocation between those items depends on the owners financing arrangements. As discussed in section 4.7.1, principal repayments are made out of the landlords return on equity.

The amount to be included in the fair market rent level as a return on investment in the property equals the dollar value of the rate base multiplied by the required rate of return. Section 3.1.3.2 discusses several alternative methods of determining the values of the rate base and the required rate of return. The choice of approach for use in the FMR system is not an arbitrary one. The approach must be both workable and consistent with the overall concept of the FMR system. Further, the rate base and rate of return calculations must be consistent with each other. In section 3.1.3.2 it is observed that there

10. Capital outlays are expenditures for which the balancing revenue is received over a period of years (depreciation); hence, if rent were being determined so as to cover costs on an individual building basis, a distinction would have to be drawn between capital and non-capital outlays. When considering the industry on an aggregate basis, however, capital expenditures and depreciation expense will tend to balance out; hence, capital expenditures can be used rather than depreciation expense in the determination of the operating costs factor in the calculation of fair market rent. If the data show that certain types of capital expenditures fluctuate significantly from year to year and therefore could introduce instability into the calculated fair market rent level, they could be entered into the calculation on a three-year (or five-year) moving average basis in order to smooth out their impact on the fair market rent level calculation.

11. In general, the value of the building will decline although value of the land tends to increase. For purposes of calculating the fair market rent only the net change in value needs to be considered. That is, how much does the owner sell the property for as compared to the amount originally paid for it. Note that part of the increase in value could be the consequence of capital investments which were included in the operating cost category. The capital gain will offset the operating cost so that, on average, capital expenditures which increase building values will have no net effect on rents. See the discussion of capital value effects below.

are two philosophically incompatible principles which underlie the different techniques for valuing the rate base: cost recovery and market simulation. The market simulation approach was shown to be the one which is consistent with current property development and ownership practices for privately financed rental housing in Ontario. Only if the radical policy decision were taken to convert the private rental housing industry into a public utility could the cost recovery approach be used. Because the prospect of this development in the rental housing industry is unlikely, it is assumed for the purposes of this Report that the market simulation approach will be taken in determining the rate base.[12] That can be done by using the market value of the property as the rate base.

Quirin (1986) identified two problems in using the market value as the rate base in the context of rate base-rate of return applied on an individual residential complex basis: appraisals and circularity. Neither of those problems would cause difficulties within the context of the FMR system which would use only aggregate data in determining the fair return guideline rate.

Appraisals would not be needed since there is no need to determine changes in individual property values. Data on actual sales could be used to develop an index of the increase in property values from year to year. This could be done on a province-wide basis or on a regional basis as discussed in section 5.2.3. Once the index of property values has been derived, year to year changes in the rate base of the total sample of landlords could be calculated easily.

In introducing the FMR system, initial property values for use in the rate base would have to be calculated for all buildings in the sample for which data are collected. If an historical property value index is derived, then the property values used in the first year of the FMR system could be based on either the original cost of developing the property, if records are available, or an actual selling price at some time prior to the introduction of rent regulation.[13]

Circularity is the other problem identified by Quirin (1986) which makes the market value approach to determining the rate base unacceptable when used on an individual building basis. In the context of fair return rent control, however, the circularity problem can be avoided. The reason circularity is a

12. Under a public utility form of land holding, the cost recovery approach to valuing the rate base could be used without harming the effectiveness of the fair market rent system of regulation. Hence, even under that alternative scenario, the recommendations in this Report would stand although they would be implemented differently.

13. This would necessitate using a pre-1975 selling price to avoid getting into the complex task of determining whether the recorded selling price was a legitimate arm's length price reflecting only the market value of the building. There may be some special cases in which pre-1975 selling prices also would not reflect the true market value of the building. That type of issue could be contested by parties to the hearings held by the Guideline Board.

concern is because market values of rental properties depend in large part on the rents landlords are able to charge. If these rents depend on the market value of the property, then any property value could become self-justifying.

The way to circumvent this difficulty is to base the index of property values not only on the value of rental buildings but on the value of real estate generally. The value of a residential rental property is based not only on rental income but also its potential value in alternative uses. An index of general real estate prices will serve as a good index of the market value of rental properties.

The rate of return used in the calculation of the return on the initial investment component of the fair market rent level should be the nominal required rate of return.[14] The landlords' cost of capital is the sum of the cost of debt and the cost of equity (see Chart 4). The cost of debt can be calculated by aggregating the total mortgage interest costs of all landlords in the sample. The cost of equity can be calculated in a three-step process. First, determine the equity base by subtracting the aggregate mortgage debt principal owed by the surveyed landlords from the market value of their properties. Second, determine the required rate of return on equity using the method described in section 3.1.3.2.1 and the Appendices to chapter 3 of Quirin (1986). Third, multiply the equity base by the required return on equity.

To avoid sudden, sharp changes in the rents, a three-year moving average of the nominal required rate of return should be used in calculating the fair market rent level. That method is consistent with the principle introduced in Chapter 2 that investors need to receive a fair return in the long run. Short-run fluctuations are tolerable as long as they balance out in the long-run; hence, smoothing the effects of sudden changes in nominal interest rates will not deter investment in rental housing.

Capital Value Effects

For investors to earn a fair return on their investments, the rental income need not equal the operating and capital costs, provided they benefit from an increase in the capital value of their property. As a consequence, the calculated fair market rent level should take into account the normal or average rate of increase in property values.

For purposes of the FMR system, a 10-year moving average of the change in property values would serve as an acceptable estimate of the normal change in capital value landlords can expect on their property as a part of their normal return on investment. The normal increase in the capital value of the properties held by the surveyed landlords would be subtracted from the operating and

14. Methods of determining the required rate of return are discussed in section 3.1.3.2.1 of this Report. The approach presented in Quirin (1986) appears to be the most practical.

capital costs. The result would be the net rental revenue required for the surveyed landlords to earn a fair return on investments, aside from the tax effects discussed below.

It is important to recognize that this treatment of capital value effects is only appropriate when the return on investment is calculated using the market value of the properties as the rate base and the nominal required rate of return for the cost of capital. In effect, capital gains are treated as part of the landlords' annual returns. However, since that portion of the return is not received in cash until the building is sold, it is considered to be reinvested in the property. The rate base is increased to reflect the portion of the return not received in cash and the appropriate rate of return is allowed on both the initial funds invested and the reinvested portion of the return in earlier years.

Tax Effects

As Quirin (1986) points out, it is the after-tax return on an investment in rental housing which must be competitive with the after-tax return on alternative investments for the development of rental housing to attract capital. (p. 267) The effective tax rates for investment in rental housing differ from the effective tax rates in other industries, due to differences in tax deferral opportunities and differences in the ability to protect other income. As a consequence, it is necessary to take into account the explicit effect of taxes on the investment return.

Therefore the competitive rate of return to be used in calculating the cost of capital should be the after-tax rate of return; hence, taxes are treated as a cost of the surveyed landlords. In situations where the investment in rental property produces a tax-deductible loss which can be used to protect other income, the tax effect may be to reduce the landlords' total costs and hence lower the fair market rent level which otherwise would be calculated. Put simply, the calculation of the fair market rent level recognizes the fact that in a normal market situation tax benefits serve to reduce the required return on investment.

5.2.4 Regional Guideline Rates

The Fair Market Rent system uses the rate base-rate of return approach on an industry-wide basis. Applying that approach on a province-wide basis and determining a single guideline rate to be used throughout Ontario would be justified if changes in landlords' costs did not differ significantly among regions i.e. if the percentage difference between the projected fair market rent level and the current actual rent level were similar in the various regions. However, if costs are rising more rapidly in an area, the allowed rent in that region may

be inadequate to attract the needed supply of rental housing investment. That situation could arise for at least two reasons.

First, the cumulative effect of controls since 1975 appears not to be consistent throughout the province. The gap between the current fair market rent level and the current actual rent level probably is different in Toronto, Ottawa, Windsor and London. Some of the variation may be the result of different market conditions.

If the landlord data collected by the Staff of the Guideline Board show that this gap differs significantly for various regions[15] of the province, then the first component of the fair return guideline rate, that is the gap between the current actual and fair market rent levels, should be determined on a regional basis.

Second, although changes in most costs will be quite similar throughout the province, some changes may differ significantly. Municipal taxes and land values are the most obvious examples. That implies that the second component of the fair return guideline rate — the rate of increase on the fair market rent — should be determined on a regional basis. However, most variations will balance out over time. Furthermore, even if the yearly differences in the rates of change in fair market rent do not balance out, they would have a cumulative effect on the regional gaps between the actual and fair market rent levels. Hence, monitoring the gaps between actual and fair market rents on a regional basis would correct for both types of regional differences. Consequently, the Guideline Board should have the power to establish different regional values for the first component of the guideline rate, but the second component should be the same for all regions.

If the system were not given the flexibility to establish regional guideline rates, both the reality and the perception that the system treats landlords and tenants fairly would be compromised. However, the concept of establishing different guideline rates should not be extended to create different rates based on building or unit characteristics such as the age of buildings or the size of units.[16] All differences other than regional ones can be adequately handled by the market comparison rent review process, the topic which follows.

15. Regions considered for such comparisons should be distinctly different markets. A region could be defined as a "commuter-shed", for example. Hence, Toronto, Kingston, Ottawa and Sudbury each may be the centre of a region.

16. However, the Guideline Board should establish variances to be used in market comparison rent review hearings for comparing rents in dissimilar buildings and dissimilar units. Those variances are discussed in section 5.3 below. That should be a responsibility of the Guideline Board since the variances should be based on analysis of landlord cost data which its staff is responsible for collecting. Another body could establish the market comparison rent review variances since the use of those variances is not a part of the rent control process. However,

5.3 Market Comparison Rent Review

For the reasons elaborated in Chapter 2, the FMR system must result in similar rents being charged for similar units in order to ensure tenants are treated equitably among themselves. Ordinarily, in the unregulated market, this would be the prevailing situation as the result of competition. However, as consequences of rent regulation in Ontario: 1. many rents in regulated complexes are below the fair market level by varying and, in some cases, substantial amounts;[17] and 2. rents in unregulated complexes are either at or in excess of the fair market level.[18] It is imperative that both landlords and tenants have an opportunity to correct rents which are out of line with the prevailing market rent for similar units. The application of the guideline rent increase set by the fair return rent control system would not achieve that end. Although the guideline rate can be used to ensure that the average rent level in the market is at the fair market rent level, it cannot determine fair market rents for individual units. The component of the FMR system called market comparison rent review would give landlords and tenants the means to achieve that result.

Since the function of market comparison rent review hearings is totally different than a fair return rent control hearing, the procedures and operations would be markedly different. The rent control hearing undertakes a detailed analysis of the costs of the industry in order to determine a guideline rate, while the market comparison review process compares rents to ensure that similar rents would be charged for units of similar value. As a consequence, the Review Officers who administer market comparison rent review, would be distinct from the Guideline Board which administers fair return rent control.

As was the case with the discussion of fair return rent control, this Report does not elaborate on all details for implemention of the market comparison rent review component of the FMR rent regulation system. Certain specific issues do need to be addressed, however.

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since the variances should be applied on a consistent basis in all rent review hearings, they can be considered to be general market variances. As such, it is consistent that they be set by the Guideline Board and that landlord and tenant representatives be invited to comment on them as part of the hearing process which also examines the fair return guideline rate.

17. Rents for similar regulated units may differ for a number of reasons. Some landlords chose not to go to rent review and accepted lower increases than were permitted others landlords in similar circumstances who did apply for rent review. Other landlords may have comparatively high rents as a result of charging increases in excess of those permitted by rent regulation legislation. Even among landlords who did go to rent review and are charging legal rents, the rents they were permitted to charge may have differed substantially due to differences in costs, especially if the difference was that one building was sold and refinanced while another was not. As a result, units which are similar and hence of equal value from the point of view of tenants, may have substantially different rents.

18. See section 1.4.6 of this Report.

5.3.1 Market Comparison Hearing Procedures

One major difference between the fair return rent control process, which would require no more than one hearing each year, and market comparison review is that there would be as many hearings across the province as were called for by the landlords or tenants of individual buildings. A hearing would be conducted by a Review Officer, one of a number of such officials, and attended only by the affected landlord and tenants or their representativess. While the control hearing could take several weeks to complete, review hearings normally could be completed within an hour or so.

The only information required for market comparison review hearings would be the rents in building being reviewed and rents in those buildings considered comparable. Assuming a universal rent registry is operating which would have a record of actual rents, the information would be readily available and should not be contentious.[19] An issue in a review hearing which could be contentious is the choice of the sample of buildings to be used as the basis for the rent comparison. In that regard the practice could be best handled in a manner similar to assessment reviews. An administrative official of the Rent Review Commission[20] would be responsible for assembling the necessary information, which would involve identifying similar complexes or buildings and calculating the average rent for the units under review and the comparison units. Landlord and tenant representatives could challenge the list of the comparable buildings with the Review Officer deciding whether the list should be amended. The rents of units under review and those in similar buildings then would be compared. The rents for each type of unit in the building being reviewed would be revised to reflect the average rent for similar units in those comparable buildings.

Market comparison review hearings could be initiated by the landlord or by a representative proportion of the tenants in the complex. The end result of review would be an adjustment by the Review Officer to reflect the average rent level for similar units in the comparable building or buildings. Rent adjustments as a consequence of the review hearing would be blended with the fair return rent control guideline increase in an order by the Review Officer determining the total allowed rent increase for each unit. To avoid sharp increases where the previous rents had been severely depressed, the order in

19. A rent registry is an essential element of the FMR system of rent regulation. An important side benefit is there is no need to determine the legal status of current rents. This issue is developed more fully in the discussion of the rent registry below.

20. The administrative officials serve a different role from the Review Officers. The former would prepare a report and recommend the action to be taken. The latter would hear the submissions of interested parties (the landlord and the tenants or their representatives) and would render a decision.

the market comparison hearing could provide that an increase of more than a specified percentage, say 10 per cent, would be spread over a period of years.[21] It is helpful to illustrate the calculation with an example.

5.3.2 Numerical Examples of The Calculation of Permitted Rents

Four situations are shown in Table 1. In all instances a guideline rate of increase of five per cent is assumed. In the first one, the decision of a market comparison review hearing is that the 1986 rent for a $400 unit is $20 below the average 1986 rent for similar units. The allowed rent in 1987 would be $441, which is 1986 rent adjusted to $420 plus five per cent. In case #2 the 1986 rent is

TABLE 1: Rent Calculation Under the FMR System

Year	Actual Rent	Average Rent for Similar Units	Rent Control Guideline Rent[1] Increase		Market Comparison Rent Review Adjustment[2]
			%	$	
Example #1					
1986	$400	$420	5%	$21	$20
1987	$441	$441			
Example #2					
1986	$400	$380	5%	$19	($20)
1987	$399	$399			
Example #3					
1986	$400	$420	5%	$21	$10
1987	$431	$441	5%	$22.05	$10
1988	$463.05	$463.05			
Example #4					
1986	$400	$380	5%	$19	($10)
1987	$409	$399	5%	$19.95	($10)
1988	$418.95	$418.95			

NOTE: See the accompanying discussion in the text.

1. The fair return rent control guideline rate is the increase required to raise the average rent in the current year to the fair market rent level in the next year.

2. The market comparison rent review adjustment is the increase or decrease necessary to adjust the actual rent to the rent which corresponds to the average rent for similar units.

21. For example, if the comparison review required that the rent in a unit be increased by $100, the order could require the adjustments be imposed in four $25 steps over a four-year period.

$20 above the average 1986 rent for similar units. The 1987 rent is therefore $399 — $380 plus five per cent for a total of $399.

The third and fourth examples assume that the adjustment is phased in over two years. In case #3 the 1987 rent equals the 1986 rent of $400 plus the $10 adjustment plus the guideline increase. The guideline increase is five per cent of the 1986 fair market rent ($420) which is $21. Hence the 1987 total permitted rent is $431. The guideline rate for 1988 also is assumed to be five per cent; hence, the 1988 rent is $431 plus the $10 adjustment plus the guideline amount of (0.05 x $441) $22.05. That totals $463.05.[22]

In the last example, the 1987 rent is $400, minus the $10 first year adjustment, plus five per cent of the $380 fair market rent. That equals $409. The 1988 rent is $409, minus $10 plus five per cent of $399. That equals $418.95.

5.3.3 Timing of Rent Review Rent Adjustments

A rent review adjustment would take effect upon: 1. the expiry of any lease existing at the time the decision was rendered; 2. the termination of the current rental unit year[23] in the case of month-to-month tenancies; or 3. the tenant voluntarily vacating the unit. In this way, large lump sum payments would not become payable by the landlord to a tenant or vice versa as could happen if the order were made retroactive. Nor would the rent change after the tenant had signed a lease or during the rental unit year by an amount which could not have been known at the time of signing the lease or continuing the tenancy on a month-to-month basis, as the case may be. Orders would be recorded in the rent registry. The occupant of a unit for which a rent adjustment was pending or remained to be phased in, would receive a reminder of that fact from the Rent Registry staff. This procedure would attempt to ensure new tenants were informed that future allowed rent increases for their units could differ from the fair market guideline rate.

5.3.4 Absence of Comparable Buildings — Use of Variances

In some localities, difficulties might arise if there were few or even no units comparable to the units in a building being reviewed. Furthermore, there might be concern that in certain types of buildings rents deviate more from the fair market rent level than in other types. To solve both of those problems it would be desirable to develop a procedure for comparing the rents of units and

22. Note that if the guideline rate were applied to the actual current rent, the rent in 1988 would end up being below that of the average unit as determined in the market comparison hearing.

23. A rental unit year is defined in Volume 1, p. 34, as the 12-month period commencing with the effective date of the rental unit's last rent increase.

buildings which are not alike. This could be done by developing standardized variances so that rent differentials could be estimated based on the differences between buildings. Those variances could be determined by statistically analyzing the data collected for the fair return rent control hearing. The official variances to be used in rent review hearings could be scrutinized by the public either as part of the annual fair return rent control hearing or by periodically holding hearings specifically to examine the variances.

Examples of possible bases for variances are:

1. locational variances in land values which lead to generalized cost and rent differentials (such as the increasing premium for being closer to the central business district in large urban centres);[24]

2. facilities differences (variances may be set for pools, squash courts, etc.);

3. building age differences (new buildings might command high rents reflecting better quality);

4. access to public transportation; and

5. standards of maintenance.

The overall level of maintenance in buildings to be compared in a market comparison hearing could be the source of important disputes. To deal with that aspect of building comparisons, a rating system would be developed for use in market comparison rent review hearings.[25] A form could be used which would allow the staff of the Rent Review Commission to rate buildings in an objective way using a comprehensive checklist of maintenance items which are of concern to tenants. The checklist itself, and the value of the variances associated with different ratings would be established by the Guideline Board using its survey data.[26] Submissions to the annual guideline hearing could

24. Locational variances may not be required if regional guideline rates are established. See section 5.2.4.

25. The only practical alternative to using a maintenance rotating system would be to use actual cosmetic maintenance expenditures per unit as a measure of the level of maintenance. A landlord who spends more than the normal amount on cosmetic maintenance such as cleaning, painting or gardening normally would have a higher quality building. Positive and negative variances would reflect the quality of maintenance of the building. Expenditures could be used to measure quality since they can be more objectively determined than a direct evaluation of the attractiveness of the building.

26. The analysis should consider not only the value of the variances but whether they should be specified in dollar or percentage terms.

address issues related to the form and the variances as well as any other market comparison review procedures.

Since many variances are possible, however it is necessary to consider only those deemed significant. Furthermore, only factors which give rise to differences in value to tenants, not differences in cost to landlords, should be considered. The purpose is not to convert the review procedure into a cost pass-through system but to recognize differences in the value of the units in different buildings. To the extent data permits, variances should be established for such features as the number and size of rooms, and the floor space of the unit, etc. It also might be necessary for Review Officers to make occasional discretionary decisions regarding significant differences for which standard variances have not been established.

5.3.5 Effect of Rent Review on the General Level of Rents

It may be observed that if a large number of review hearings are held and rent increases are not balanced by rent decreases, the actual average rent increase throughout the market could be above or below the rent control guideline. As a consequence, actual returns for the industry might exceed or fall short of the fair return. That should not create a problem since the next year's guideline increase would be based on the difference between the actual rent level and the rent level required for the industry to earn a fair return in the following year, taking into account the fact that actual cost increases would inevitably differ from those anticipated.

5.3.6 Frequency of Market Comparison Reviews

An important concern relates to the number of market comparison review hearings required to establish fair market rents throughout the province. It is evident that both landlords and tenants could have an incentive to request a market comparison review hearing. There might well be an initial flood of applications for review. Furthermore, hearings are likely to spawn other hearings, particularly for buildings which are among the set of comparable buildings in a hearing. Five points are relevant to the workload issue.

First, no hearing would be held unless requested by the landlord or a representative percentage of tenants of a building.

Second, ordinarily only one market comparison rent review hearing would be held for each building. A second hearing would be required only if there were significant physical changes in the building or in the level of service affecting the value of its units relative to those in other buildings. Hearings would not be precipitated by an increase in interest rates or operating costs as they are under the current cost pass-through system. Fair return rent control would take into account all cost factors.

Third, hearings would be relatively short since the matters to be dealt with would be limited.

Fourth, once a set of mutually comparable buildings is established for purposes of a review hearing, that set of buildings would serve as the comparables if other buildings in the set or even other similar buildings in the area were reviewed. Hence, once the system got underway, preparatory work for hearings would decline significantly. It should be noted that a market comparison hearing would establish rents only for the building being reviewed. Even if the building being reviewed had been used as a comparable for an earlier review hearing, the question of comparability with the same set of buildings could be the subject of submissions by either party. New information could justify the rejection of some or all the buildings as comparables. New information could also support the reconsideration of variances which were not taken into account in the earlier decision.

Fifth, negotiation which is discussed in section 5.5 below could reduce the flow of requests for review, especially for smaller buildings which otherwise could put the greatest burden on the system.

5.4 Single Building Rent Review

At the present time in Ontario it is common for rents for similar units within a building to differ significantly. The cost pass-through system, particularly since the practice of equalization was prohibited by the 1982 Act, has perpetuated and increased inequities within buildings which existed at the time regulation was introduced in 1975.[27] The market comparison feature of the FMR system would provide an opportunity to reduce rent differentials for similar units within a building as well as for units in different buildings. However, if neither the landlord nor the tenants consider it necessary to conduct a full market comparison of rents since they are concerned only about differences in rents for similar units within the building, then a simpler process — single building rent review — which compares only rents within the building would be adequate.

A single building rent review hearing could be initiated by the landlord or by any number of tenants in a building if it were considered that rent differentials within the building are not reasonable. Hence, rents could be equalized without requiring a market comparison review hearing by grouping the units into types and adjusting the rents for units in each group to the average rent for that group. All units in a complex would be considered in that case

27. Chapter 10, Apportionment of Total Rent Increase, of Volume 1 of this Report addresses the issues which arise when the rents for similar units differ significantly and when rents for dissimilar units do not reflect the differences in their values.

and the total revenue received by the landlord from the building would be unchanged.

Single building review hearings also could be used to deal with matters specific to one or a few units within a complex. For example, if a small landlord has renovated only a few units in a building, he could request a rent differential between the renovated and unrenovated units. In that case, the rents for the renovated units could be increased without affecting the rent in other units. The rents for the renovated units should reflect market rents for units of similar quality. The differential could be established either by determining the market rent for similar units or by reference to the established variances.[28]

Alleged gouging or economic eviction[29] cases also could be dealt with by single building rent review hearings which would determine the normal rent level for similar units.

Whatever the purpose of the hearing, if it is shown that rents for some units are out of line with the rents for similar units within the building or if the differences in rents for various units cannot be justified on the basis of allowable variances, then rent adjustments for the units reviewed would be ordered. As in the case of market comparison rent review, large adjustments could be spread over several years.

5.5 Negotiation

Because the Fair Market Rent system directly determines the theoretically correct rents which should be charged, all rental buildings in the province should in theory become involved in a market comparison hearing. In that event, the fair return rent control guideline rate, in combination with the review orders, eventually would result in the rents for all units being adjusted to the fair market level and kept at that level as it changed due to inflation and other economic factors. In practice however, there would be a physical limit to the number of complexes which could be reviewed annually and it could take some time before every unit could become the subject of a market comparison rent review. As well, there would be complexes where neither the landlords nor the tenants wished to engage in the review process. That has been the case with the existing Ontario cost pass-through system and many people would continue to choose to avoid any involvement in what is inevitably an administratively complex and formal regulatory process.

28. The variances discussed in section 5.3.4 could be used in single building rent review hearings to facilitate comparisons among dissimilar units within buildings.

29. Both gouging and economic eviction are defined and discussed in sections 4.2.1 and 4.2.2.

Negotiation[30] would serve to reduce the administrative load on the regulatory system without significantly compromising its integrity. Under the FMR system, the market comparison review process could be left in the first instance to negotiation between landlord and tenants. The rental data available through an established rent registry[31] would help determine the general level of rents in the area and enable the parties to work out for themselves a rent which is in line with the rent being charged for similar units in other buildings. This approach allows landlords and tenants to work out a mutually acceptable rent without getting involved in the hearing process. That is desirable both for reducing the workload and for dealing with special cases which may go beyond the general rules used in the formalized hearing process.

Since there is no guarantee that the negotiated rents would correspond to the fair market rents which would be determined by market comparison rent review, either the landlord or the tenants would be able to request a review at any time. A negotiated rent would be superseded by an order pursuant to a market comparison rent review hearing. If a landlord and tenant cannot agree on the rent, then the fair return rent control guideline rate[32] would be used to determine the maximum which could be charged, unless either the landlord or tenants request a market comparison hearing.

The purpose of allowing negotiation is to avoid unnecessary hearings. Once a hearing is held the ordered rent would be considered to be the fair market rent and the rationale for allowing negotiation would be removed. It would follow that negotiation of rents would not be permitted if the building rents had been adjusted to the fair market level by a review hearing at any time in the past.

The protection available to tenants would be that they could not be forced to accept an increase which raised their rent above the registered rent. However, any rent agreed to by a tenant would be binding for the duration of the lease, or one year, in the absence of a lease, subject to two limitations. First, if the tenant could establish to a court that any form of coercion had been used to force his agreement to paying in excess of the registered rent, the agreed rent should be revoked. Second, in the event a market comparison or single building review hearing establishes a rent which is different than the rent specified in a lease, the ordered rent would override the lease.

30. See the discussion of optional or mandatory regulation in section 3.1.2.

31. See the discussion of the rent registry in section 5.6 below.

32. Having regard to the manner in which the guideline would be determined it is obviously not a matter in which the process of negotiation could serve any purpose.

Since the rent a tenant agreed to pay would be a legal rent, the tenant could not demand repayment of any rent which had been agreed to, even if the rent was above the registered rent.

Provided tenants are informed of their rights, it is reasonable to assume that in general tenants will not agree to a negotiated rent which exceeds the old rent plus the guideline increase unless it were evident that that rent would be below the rent being paid for similar units in other buildings. In other words, they would only agree to a higher rent if it is evident that a higher rent would be awarded by a market comparison hearing in any case. In general, the negotiated rent would be closer to the true fair market rent for the unit than the straight application of the guideline rate without a review hearing.

To ensure that tenants know their rights a negotiated rent would not be valid unless the tenant had signed an official rent increase form which showed the old registered rent, the guideline rate, the new registered rent, the phone number of the rent registry and other relevant information. The staff of the rent registry could provide tenants who call, with confirmation of the registered rent and other information regarding their rights under the FMR system.

5.6 FMR and the Rent Registry

The point was made in Volume 1 of this Report that there are two reasons for setting up a rent registry. It was said:

> First, tenants consider it necessary to have a source of information regarding the rents that they should be charged for the premises they are occupying or considering renting. Second, a rent registry would be a means of determining whether landlords were observing the regulated limits on rent increases. (p. 212)

These remarks were made in the context of a restrictive system of rent regulation which does not permit rents to be privately negotiated. The registry, however, is also essential to the FMR system of rent regulation since it would serve as the primary source of information on comparative rents to be used in market comparison hearings. In addition, the registry would provide landlords and tenants with the information they need for negotiating a reasonable rent, relative to the rents for similar units.

In order to fulfill its function, the registry should record both the actual rent being paid by the tenant and the registered rent. The registered rent would be the maximum the landlord could charge without the tenant's consent. It reflects the base rent, the annual guideline increases and any orders resulting from market comparison or single building rent review hearings.

5.7 Illegal Rent Predating the FMR System

There are always people prepared to transgress a regulatory system which inhibits their freedom of action. This has certainly been the case under the system of rent regulation operating in Ontario since 1975. Some landlords may even argue that because the regulatory system has made it impossible for them to earn an adequate return on investment, they feel justified in charging illegal rents. Because the FMR system of rent regulation is designed to restore rents to a fair market level, that argument could no longer be made. Nor should the administration have any reason for holding back on effective enforcement of the limits imposed on rent increases by FMR regulation. Moreover the opportunities for evasion or avoidance would be reduced greatly by the existence of a rent registry which would provide tenants with a means of easily checking the validity of their rents.

Illegal rents, if they would occur at all under FMR regulation, should constitute no more than a minor problem once the regime of fair market rents has been in force long enough to permit the market to return to a balanced situation between supply and demand, and hence normal vacancy rates. In a balanced market, competitive forces would reinforce the constraints of the regulatory system. However, at the time of introducing the FMR system, a question would arise regarding what to do with any unresolved claims for refunds of illegal rents charged under the pass-through system being replaced. There is no evidence regarding either the number of possible claims or the aggregate amount of illegal rent refunds to which tenants have a legal right. Indeed the jurisprudence regarding the circumstances which give rise to illegal rent claims is still developing as the courts struggle with the interpretation of the applicable legislation. The amount involved probably is substantial and certainly the claims have high emotive value to both the tenants and landlords.

The 1979 Act placed no limitation on the time within which tenants had to claim illegal rent refunds. The 1986 Act prescribes an elaborate process of notices and claims designed to hold an even hand between landlords and tenants. The procedure proscribes any refund claim for excess rents paid more than six years before the tenant files an application for refund. The 1986 Act moreover gives the landlord an opportunity to settle the amount of potential claims before the limitation period comes into operation. It is quite possible, however, that when the FMR system becomes operative, assuming it is adopted as government policy, there will be undisclosed as well as disclosed but unsettled claims for refunds of illegal rent under the 1979 and 1986 Acts. These claims constitute rights accrued to tenants and it would be contrary to basic legal principles to declare that they should lapse.

Notwithstanding the possibility that rents which are illegal under the current law would be found to be fair market rents under the FMR system,

the Inquiry takes the position that it would be wrong to expunge existing statutory rights by the retroactive application of a concept of fair market rent which did not govern rent regulation at the time. Accordingly, undisposed claims for refunds of illegal rents remaining when FMR regulation supersedes the current system should continue to be governed by the provisions of the 1986 Act. The consequence could be that a few landlords might be charged with refunds under that legislation while at the same time they were entitled to a rent increase in respect of the same unit under FMR regulation. The possibility of such anomalous situations detracts from neither the validity of the FMR system nor the legality of the current system.

5.8 Treatment of Post-1975 Buildings

The 1986 Act treats buildings first rented before and after 1975 on different bases. The FMR system would draw a different distinction. All buildings first rented before the introduction of the FMR system would be treated on the same basis; whereas buildings first rented after the introduction of the FMR system would be subject to a temporary exemption. Consequently, this section is divided into two parts.

5.8.1 Buildings First Rented Before the Introduction of the FMR System

In implementing the FMR system in Ontario, consideration would have to be given to whether rent differences between buildings which had been and those which had not been controlled since 1975 and 1986 should be taken into account.[33] As noted in section 1.3.1, Slack (1986) reviewed several studies of the rent levels in the controlled and uncontrolled sectors of Ontario's rental housing market and concluded that average rents for controlled units were somewhere between 7.5 and 11 per cent below the competitive market level and average rents for uncontrolled units were between nine and 10 per cent above the competitive market level. Consequently, it is likely that the data collected for the first fair return rent control hearing would show a difference between the two sectors in terms of the gap between the actual and fair market rent levels.

To segment the market in terms of pre- and post1975 regulatory status would cause problems. The average gap between the two categories is not helpful in determining the appropriate rent adjustment for particular buildings. Among pre-1975 buildings, for example, there are significant differences between buildings which went to rent review, particularly those which changed

33. The possibility of different treatment for buildings first rented after the FMR system is introduced is discussed in the following section 5.9.

hands with the purchaser passing through financial losses, and those which have never been to review, particularly where the landlord complied strictly with the statutory rate of rent increase.

Given the extent by which the relationship among rents of similar units has been distorted by rent regulation since 1975, the most feasible course of action would be to apply a single guideline rate to all units regardless of age, regulatory status and the history of rent increases. All of those differences among units should be handled on an individual case basis by means of market comparison rent review.

5.8.2 Buildings First Rented After the Introduction of the FMR System

A separate issue relates to the initial rent landlords should be allowed to charge for units which come on to the market after the FMR system is implemented. Those rents could be set by a market comparison rent review hearing; however, there would be advantages to exempting new buildings from rent regulation for a five-year period. The exemption period would help to attract investment in new rental housing without creating hardship for tenants, since the rents in the new building are effectively constrained by market forces.

The five-year exemption, as it will be called, was not a pressing issue when rent regulation was introduced in 1975. New construction was exempt from that Act but it was due to expire before a significant amount of new construction could be completed. Although the 1986 Act applies to new construction, the issue of the five-year exemption was not raised in discussions preceding the passage of that legislation.

It is widely recognized that to exempt new buildings from regulation for a five-year period would increase the supply of new rental housing. Increasing the landlords' flexibility in setting rents would make investment in the industry more attractive. It also is widely recognized that landlords would not be able to exploit that freedom to reap high profits. Their costs are higher than those for older buildings and they have difficulty attracting tenants who are willing to pay even a break-even rent.

Furthermore, after the exemption period has expired, either the landlord or the tenants would be free to initiate a market comparison rent review, which would provide the opportunity to correct rents to make them fair market rents if an adjustment is needed.

5.9 Comparison of the Statutory Cost Pass-Through System of Rent Regulation With the FMR System

The 1986 Act continues, with amendments, the system of rent regulation established by the 1979 Act. It combines the rent control guideline, which is now made applicable to all rental units, with rent review which may be resorted

to, as before, as a ''blow-off valve'' by landlords. The terms rent control and rent review used to identify the two parts of the system will not be found in the language of either statute. They were given formal meanings by the Inquiry in Volume 1 of its Report. (The regulatory provisions of the 1979 Act were contained in part XI of the 1979 Act under the heading ''Rent Review''. This became part VI of the 1986 Act headed ''Rent Regulation''). Rent review sets rents for a complex which are based on a review of the circumstances of the particular complex. The FMR system uses the terms fair return rent control and market comparison rent review because they are descriptive of the processes to which they relate but there are basic differences between the statutory processes and the FMR processes. The discussion of those differences is divided into two sections. Section 5.9.1 addresses the different ways in which the guideline rates are determined and section 5.9.2 addresses the difference in approach to rent review under the two systems.

5.9.1 Differences in Setting the Guideline Rate of Rent Increase

The cost pass-through guideline rates of eight per cent, six per cent and four per cent since 1975 were set by government without any indication of the reasons which led to their adoption. An assumption is that they reflected the inflation rate at the time they were adopted. The guideline rate under the 1986 Act is determined by the application of two formulae which are set out at length in the legislation. One is the Building Operating Cost Index or BOCI which in turn is a factor in the calculation of the Residential Complex Cost Index referred to as RCCI. The latter percentage becomes the guideline rate of rent increase allowed for the following year.

In a publication dated December 1986 entitled ''About Rent Review'' the Ministry of Housing made the following comments about the BOCI formula for determining the rent control guideline rate.

> A formula was devised which incorporated more than 20 items impacting on the cost of *maintaining a typical well-run rental building*.
>
> It was discovered that the best way to monitor the change in the cost of most of these items was simply to use the appropriate parts of the Consumer Price Index, which measures the change in costs of most building maintenance items.
>
> The result — a formula for computing the rent review guideline each year based on the economic conditions faced by everyone.
>
> The result — fair treatment for landlords.

> The result — good building maintenance and inflation protection for tenants.
>
> And so, under the new Act, the rent review guideline becomes responsive. Each year, the Ministry of Housing will calculate the guideline for the upcoming year and announce it by August 31.

This approach to rent regulation assumes that the base rents to which the allowed rent increase is added were fair market rents. If the base rents were in fact high or low relative to the fair market rent level the pass-through of costs will not adjust the rents to the fair market rent level.

The fair return guideline rate under FMR regulation is determined in a fundamentally different way. It is the rate of rent increase required to move the actual market rent level in the industry, as determined by a survey of the market for the previous year, to the estimated fair market level in the following year. Although the fair market rent level so estimated will include projected cost increases, the guideline rate may be above or below the percentage increase in costs to make up for the gap between the current actual and fair market rent levels.

Fair market rent control seeks to achieve the objectives of rent regulation described in Chapter 4 consistent with the directive to the Inquiry, implicit in the Order in Council, that rents be fair. It does so in a direct fashion by undertaking the collection of data required to set a rate of change which will move rents toward the fair market rent level while ensuring that it is not exceeded, rather than leaving this vital matter to chance. The cost pass-through system not only builds on a base which is not aligned with the fair market rent level but uses formulae under which the increase in rental income may differ significantly from the amount by which landlords operating costs increase. After a few years the result of the application of RCCI to current rents could be either to bring them closer to or move them further away from fair market rent than they are at the present time. There is no mechanism for determining how large the gap is or whether actual rents are above or below fair market rents. The RCCI determined guideline and the FMR guideline are not alternative methods of estimating the rate of increase in the costs of the average landlord for the following reasons.

The RCCI does not take into account financing costs. Since the change in financing costs is not related to the change in operating costs the RCCI may differ significantly from the rate of increase or decrease in the fair market rent.[34] FMR rent control uses an actual survey of landlords' financial data to determine that essential factor in a rent control guideline.

34. For example, if the inflation rate and interest rates are stable, financing costs (debt and equity)

The RCCI determined guideline estimates the change in landlords' costs using the Consumer Price Index (CPI), CPI subcomponents, and indices of labor income. This has the attraction of avoiding the need for collecting actual data on landlords' costs by using existing data sources. These sources, however, are only loosely related to landlords' costs hence they are not reliable indicators of actual change in the costs of landlords. As a consequence the BOCI cannot be considered a good estimate of the true rate of change in landlord operating costs let alone the change in rent necessary to reach the fair market rent level. In fact there is no reason that the BOCI calculation used in the RCCI approach is a better estimate of the increase in operating costs than a much simpler rough estimate such as the increase in the CPI alone. The complexity of the calculation may give the appearance of greater accuracy but accuracy in that regard requires the collection of data.

It also should be noted that the RCCI, which is used as the rent control guideline rate, equals two per cent plus 2/3 of the percentage increase in the BOCI.[35] Over a period of years, the average guideline rate (RCCI) will equal the average estimated increase in costs (BOCI) only if the BOCI is six per cent. It will be less than the BOCI if the BOCI is more than six per cent and more than the BOCI if the BOCI is less than six per cent. Even if the estimates used for landlord costs were accurate, the RCCI will almost certainly deviate from changes in the operating costs of landlords. Whether it is high or low will depend on whether the inflation rate averages below or above the six per cent level.

One conclusion is clear. Although the RCCI calculation makes use of a formula which incorporates "more than 20 items impacting on the cost of maintaining a typical well-run rental building," the increase in rental income allowed by the RCCI may differ significantly from the amount by which landlords' operating costs increase. The general rent level is likely to deviate even further from the fair market rent level.

Clearly, after a few years the rents which will result from the application of the RCCI to current rents could be either closer to or further away from fair market rents than they are at the present time. The effect in particular cases will depend on where the rent is now relative to the fair market rent, future economic conditions and how the indices used for calculating the BOCI relate to actual increases in landlord costs.

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will be constant. With a five per cent inflation rate, operating costs may rise by about five per cent while financing costs may be unchanged. Assuming operating costs account for about half of landlords' total costs, the increase in the landlords' total economic costs (operating plus financing) will be only about 2.5 per cent.

35. The RCCI has a minimum value of two per cent.

Unless the regulatory system explicitly and accurately determines the fair market rent level, it cannot attract confidence in its ability to achieve the goal of fairness to landlords and tenants. If, for the sake of avoiding a large data collection exercise, a regulatory system is compromised so much that it is seen to be less fair than the unregulated market by either investors or tenants, that system will do more damage than good to the rental housing market. To put it simply: a poorly designed regulatory system may be worse for both landlords and tenants than no regulatory system, particularly if it continues for many years.

5.9.2 Differences in the Rent Review Process

There is no resemblance between the existing system of rent review in Ontario and market comparison rent review under the FMR system.[36] The existing review mechanism is used to pass an individual landlord's actual costs through to the tenants. Although the 1986 Act has made several changes to the allowed rate of rent increase, it is conceptually the same with the exception noted below as it was in the 1975 and 1979 Acts.[37] The significant change is that in determining the total rent increase for a residential complex, no part of which was occupied as a rental unit before January 1, 1976, an item in respect of a return on the landlords' equity may be included.[38] Other changes in the method of calculation affect all complexes but do not alter the system.

The FMR system rejects the cost pass-through approach to the review of the rents of individual landlords for the reasons set out in the discussion of cost pass-through rent regulation in section 3.1.3.1 The review mechanism is replaced by a procedure which focuses on ensuring that rents for similar units

36. The Inquiry adopted the name market comparison rent review — which on occasion is shortened to rent review – because review is an accurate description of the process of comparing rents.

37. Section 134(1) of the 1979 Act reads as follows: The following rental units are exempt from this Part:

    (c) a rental unit situated in a building, no part of which was occupied as a rental unit before the 1st day of January 1976.

38. The calculation methodology has been changed in a number of ways, including: 1. the removal of the $750 exemption; 2. the use of prescribed rather than actual rates of cost increases in most circumstances for the landlords' operating cost components; 3. costs no longer borne provisions; 4. the restoration of equalization which was suspended by the 1982 Interim Act; and 5. the introduction of special provisions for "chronically depressed" rents. Although those changes alter the calculation of the allowed rent increase, they do not alter the system in terms of the approach to rent review using the type of systems set out in section 4.1. Hence, the comments on the cost pass-through approach remain valid despite the changes made to the system by the 1986 Act. The review procedure is quite different, but this does not affect the calculation of the allowed rent increase.

are similar. Landlord costs are not relevant to this review process, since cost considerations are fully and properly accounted for by the fair return guideline rate.

5.10 Concluding Comments

The Fair Market Rent system is intended to establish rents at a fair market level and keep them from exceeding that level. It combines a rent control guideline with a rent review system. The guideline will permit rent increases which would allow the industry as a whole to earn a fair return. It would be set by the Guideline Board and would have two components, the percentage by which current rent levels fall short of or exceed the current fair market level and the percentage by which costs would increase in the projected year. Included in costs is an allowance for return on investment. This requires a determination of the capital employed — the rate base — and the cost of raising and retaining it — the rate of return. The determination of the rate base would recognize the current changes in the value of the property.

The rent review feature of the FMR system would take the form of market comparison rent review whereby rents of similar units in different buildings with similar characteristics would be compared. The rent adjustment for each unit, resulting from the combined effect of a guideline increase or possible decrease and a comparison adjustment, would be applied prospectively. Consequently, there would be no lump sum payments between landlord and tenants in respect of past rents in excess of or less than the fair market rent as determined by the FMR system.

Chapter 6

Conclusions and Recommendations

This Chapter provides the conclusions which have been drawn from the analysis of rental housing policies in the five preceding chapters. The conclusions lead to the Inquiry's recommendations which deal with features of the Fair Market Rent system described in Chapter 5.

This Chapter is organized into three sections: Section 6.1, states the basic principles which underlie the Inquiry's approach to the matters directed to its attention by the Order in Council. As was observed in the Introduction, the question of whether or not rents should be regulated was not included in the Order in Council. However, the Inquiry's treatment of how to regulate rents would not be complete without some consideration of the circumstances under which rent regulation is needed. This is done in section 6.2. The Inquiry's recommendations are presented in section 6.3 along with brief commentaries and cross-references to relevant sections of the Report.

6.1 Principles Underlying the Inquiry's Recommendation

The analysis of rental housing problems in the preceding chapters is built on five principles which express the Inquiry's view of what is fair to both tenants and landlords. The form and content of the recommendations in this chapter are governed by those principles. They are:

1. All tenant households should have access to decent housing suitable and adequate to their needs.

Comment: Access as used here takes in both affordability and availability. Rental housing programs should be such that decent and adequate housing will be available for all households whether or not they can pay the fair market

rent for their units. Consequently, households which cannot afford the market rent for suitable housing should be assisted to reduce their affordability problem.

2. Private investors and landlords should be the major suppliers of residential rental housing.

Comment: It is taken for granted that while socially assisted, non-profit, co-operative and other non-private-sector housing will form an important part of the total rental housing stock, the dominant role of the private sector will continue in the foreseeable future.

3. Private investors must earn a competitive return on their investment.

Comment: This point has been developed at length in Chapter 2 and in section 4.7. The private market will remain viable only if investors earn a competitive return by charging fair market rents. This is a prerequisite to the implementation of the second principle.

4. Rents in the private market should be as low as is compatible with a fair return being earned by investors.

Comment: This principle has a general and a particular application. The general application is that over the long term the level of rents in the private rental industry should not exceed the fair market rent level. That issue is discussed in section 4.3. The particular application is that market aberrations in the form of excessive rent charges and rapid escalations of rents due to rental housing shortages should be restrained. Those issues are discussed in sections 4.2 and 4.4.

5. Tenant households should be protected against economic eviction.

Comment: The security of tenure provisions of the Landlord and Tenant Act are incomplete unless some provision is made to protect tenant households against economic eviction, i.e. where the landlord imposes a rent he knows is beyond the financial means of a tenant. Section 4.2.2 discusses economic eviction.

6.2 Under What Circumstances Should the Rents of Residential Tenancies be Regulated?

In the context of this Report three aspects of the question of whether rents should be regulated must be considered:

1. Should rent regulation in some form be continued in Ontario?

2. If under a scheme of rent regulation a balance between supply and demand has been achieved in the market, and vacancy have rates returned to normal levels, should rent regulation be continued?

3. If both 1. and 2. are answered in the affirmative, then is the form of rent regulation, that is appropriate given the current Ontario market conditions, appropriate in a balanced market?

The first question is with regard to the immediate future of rent regulation in Ontario. The current situation is that more than a decade of restrictive regulation has brought the market to an unsatisfactory condition as evidenced by the low vacancy rates, and evasion and avoidance of the regulatory rent limits. Moreover the cost pass-through system of rent regulation is unsatisfactory in a number of ways and the building-by-building approach has resulted in inequities among landlords and among tenants.

The Inquiry is impressed by the evidence of competent observers regarding the extent of the spread between the current rent level in the pre-1976 controlled market and the rent level which likely would have prevailed in the absence of rent regulation. Even if supply and demand were currently in balance, rents on average would be likely to increase by 10 per cent in pre-1976 buildings. Given the low vacancy rates in most urban centres in Ontario, and the wide variation in rents for similar units, actual increases could be substantially larger in many cases if the market were abruptly deregulated. The result would be quite unacceptable. Consequently, the answer to the first question is that a rent regulation scheme is required in Ontario at the present time which would allow the market to adjust to a regime of fair market rents in a controlled and orderly manner. That goal can only be accomplished by introducing the FMR system. Furthermore, once the goal of adjusting rents so that fair market rents and no more are permitted, the system will have to continue until a balance between supply and demand has been re-established. Until that time, rent regulation will be needed to avoid a rapid escalation of rents due to the shortage of rental housing.

The time required to reach that level would turn on two factors: 1. the size of the gap between the present rent level and the estimated fair market rent level, and 2. the portion of the gap included in the guideline rate of increase each year. The time required can only be estimated since the data required to estimate the gap are not currently available, but it might take as long as five years.

When rents reach the fair market rent level as determined by the Board it is probable that housing would still be in short supply and tenants would be vulnerable to high rent charges. It is difficult to predict when the supply of new rental housing would be sufficient to produce a normal vacancy rate

situation and bring rents down to a fair market level. It may take many years for private investors to feel confident that the policy of fair market rent would be continued so as to justify their risking new investment in rental housing in any substantial way. The vacancy situation also would be affected by any government housing programs for subsidized ownership or rental. Rent regulation will be necessary at least until such time as the market supply balances demand.

Once the FMR system has brought rents to the fair market level and normal vacancy rates have been re-established, the second question becomes relevant. Should rent regulation be continued? The analysis in Chapter 4 identified three possible reasons for a policy of rent regulation which relate to housing market problems: 1. to protect tenants from excessive rent charges, 2. to stop landlords from charging high rents during periods of inadequate supply, and 3. to limit excess profits in the rental housing industry.

It is evident that some form of rent regulation will be necessary even after the transition to normal market conditions has been accomplished. However, that conclusion raises the third question: is the FMR system the appropriate regulatory system under normal market conditions?

With regard to the first reason for rent regulation — protection of tenants against excessive rent charges — it is apparent from Chart 1 in Chapter 5 and the related discussion that only the market comparison rent review and single building rent review arms of the FMR system would be required. The fair return guideline rate is not relevant to this rationale. Although this problem appears to be a relatively infrequent occurence, the consensus of critics of the rental housing market is that it is a problem which requires attention. The opinion of the Inquiry is that this problem is a reason for regulation and that the appropriate remedy for tenants who believe they are being subjected to such rents is ready access to the market review process under FMR regulation.

The second reason - avoiding high rents during periods of inadequate supply - necessitates a guideline rate, but it need only be imposed where conditions are conducive to an escalation of rents to a level above the fair market level. The implication is that although the guideline rate could be removed when the market is in balance, it would be desirable to continue the data collection and rent level determination by the Guideline Board. This would ensure the reintroduction of a guideline rate on a temporary basis where conditions warranted it. If an arbitrary guideline rate were established to control rent increases under tight market conditions, there would be a serious risk that the rate would be set too low and post-1975 experience would be repeated.

The third reason — excess profit — would necessitate the continuation of the FMR system on a permanent basis if the problem were found to be significant. It should be noted that the data needed to determine empirically whether or not excess profits are a problem in the absence of rent regulation

are not currently available; however, the data would be available after the FMR system had been in place long enough to accomplish the transition to normal market conditions. Furthermore, by continuing the data collection function of the Guideline Board, the situation with regard to excess profits could be monitored on an on-going basis.

Hence, with regard to the third question the market comparison and single building review functions of the FMR system should be available on a permanent basis, although those activities would be greatly reduced once rents generally are fair market rents. The mere existence of the review mechanisms should forestall most excessive rent increases. In addition, as well as dealing with the problems of high rents, the data collection function of the Guideline Board should be continued on a permanent basis, so that the existence of excess profits can be determined and a guideline rate established if necessary. It also would be desirable to establish guideline rates on a regional (or municipal) basis because the market conditions which give rise to escalating rents and excess profits generally are local phenomena.

It may also be observed that maintaining the market survey on a permanent basis would be useful in helping government decide when enhanced supply programs subsidizing private construction and enlarging the supply of socially assisted housing would be in order. The usefulness of the survey for this purpose would be increased if data were collected on tenant incomes as well as landlord costs. Although those data are available from the Census, annual data would be helpful for policy formation.

The Inquiry recognizes that no regulatory scheme can be perfect. Before deciding that the application of a regulatory system is warranted, the possibility of imperfections and deviations from the ideal purpose for which it was designed must be balanced against the imperfections of the unregulated market it is intended to replace. Subjective opinion must be called on. The Inquiry can only say that in its opinion there are valid reasons for rent regulation and the application of the processes of FMR regulation would be justified.

6.3 Recommendations

Recommendation 1. **That the current cost pass-through system of rent regulation be revoked and replaced by the Fair Market Rent (FMR) system proposed by this Inquiry.**

Comment: The goal of rent regulation laid down in the Order in Council establishing the Inquiry is that regulation should be fair to landlords and tenants. The FMR system would fulfill that goal.

1. It would be equitable among tenants and among landlords in that similar rent would be charged for similar units.

2. It would be equitable between tenants and landlords in that landlords would earn a fair return and no more.

3. Tenants who have the means to do so should pay fair market rents. The introduction of FMR would be accompanied by other programs to assist those tenants who cannot afford to pay fair market rents.

4. Rent increases to close the gap between current depressed rent levels and the fair market rent level would be phased in.

5. The FMR system also would protect tenants from aberrations such as excessive rent charges and high market rents due to tight market conditions.

The FMR system operates at two levels: the industry level and the individual building level. The operative features of Fair Market Rent regulation are covered in Recommendations two through 10 regarding fair market rent control and Recommendations 11 through 18 regarding market comparison rent review.

Recommendation 2. **That a guideline rate of rent increase be set annually which would establish the maximum rent a landlord could charge, subject to Recommendations 11 and 19.**

Comment: The central component of the FMR system is the guideline rate which would apply universally. The purpose of the guideline rate of rent increase is to adjust rents in an orderly and controlled way so that they would not exceed the fair market level. Hence, it is moderate rather than a restrictive regulatory system, as those terms are defined in section 3.1.1.2.

Recommendation 3. **That a Guideline Board be established to determine on an annual basis the guideline rate of rent increase to be used in the following year.**

Comment: The responsibilities of the Guideline Board are summarized in Chart 2 in Chapter 5 which shows the responsibilities of the bodies this Report recommends be established.

Recommendation 4. **That staff of the Guideline Board assemble data on industry operating costs, revenues and capital bases obtained from information supplied by a representative sample of landlords.**

Comment: This material is to serve as the basis for the annual determination of the guideline rent increase by the Guideline Board.

Recommendation 5. **That the fair market rent level for the industry as determined by the Guideline Board combine four elements:**

1. standard operating costs based upon data obtained from the survey;

2. the return on initial capital investment (see recommendation 6);

3. the adjustment for capital value effects; and

4. the tax effects corresponding to the average tax benefits realized by the surveyed landlords.

Comment: The treatment of those four elements is discussed in section 5.2.3.2.

Recommendation 6. **That the rate of return on initial capital investment be the landlords' cost of capital. The cost of capital would be calculated as a weighted average of the debt cost of the surveyed landlords and the required rate of return on equity investment. The weights used would reflect the average debt to equity ratio of the surveyed landlords.**

Comment: The appropriate method of determining the cost of debt and the required rate of return on equity is discussed in section 5.2.3.2.

Recommendation 7. **That the guideline rate of rent increase have two components: 1. the percentage increase required to bring the rent level for the industry up to the fair market level, subject to Recommendation 8; and 2. the percentage increase required to meet the projected increase in the fair market rent level in the following year.**

Comment: The calculation of the current industry rent level and the fair market rent level by the Guideline Board would be made annually on the basis of updated data and would correct for any error in the calculation of the guideline for the previous years.

The first component allows the actual rent level to rise to the fair market rent level over a period of years (see Recommendation 8). After the transition to fair market rents has been accomplished, that role would no longer be relevant. The continuing role of the first component is to compensate for errors in setting the guideline rate in previous years. Those errors would be unavoidable because the rate of increase in the fair market rent level built into the guideline rate, as determined by the Guideline Board, is a projected rate, and generally would not match the actual rate.

Recommendation 8. **That the first component of the guideline rate of rent increase not exceed a prescribed amount, (e.g. three percentage points in any year.)**

Comments: The intent of the FMR system is to bring rents to the fair market level using an incremental approach. The limit on the rate of increase would smooth the adjustment which otherwise might have an abrupt effect.

Recommendation 9. **That regional guideline rates of rent increase be established if analysis of the survey data indicates appreciable differences among regions exist in the gap between the current actual, and the current fair market, rent levels.**

Comment: The second component of the guideline rate specified in Recommendation 7 would not be determined on a regional basis. As discussed in section 5.2.4, the rates of increase in the fair market rent in different regions which are due to cost increases are not likely to differ significantly. Furthermore, since the second component is a projection, differences would be particularly difficult to identify.

Determining the gap between the current actual rent and the current fair market rent on a regional basis would ensure that differences that exist at the time the FMR system is introduced would be taken into account. It also would capture any regional differences in the actual rate of increase in the fair market rent after the fact, and make suitable corrections.

Recommendation 10. **That provision be made for a market comparison review procedure to be conducted by Review Officers stationed throughout the province.**

Comment: The intent of market comparison review is to adjust the rents for units in a complex which is reviewed so that they are similar to the rents being charged for similar units in other complexes. Market comparison rent review is discussed in section 5.3 of this Report. It should be made clear that market comparison rent review will not, and is not intended, to adjust rents to the fair market level. That is the function of the guideline increase. However, once the application of the guideline rate over a period of time has moved the industry level of rents to the fair market rent level, market comparison rent review will serve to ensure that the rents being paid for particular units are fair market rents.

Recommendation 11. **That for purposes of market comparison rent review and single building rent review (see Recommendation 18), similar accommodation would be determined on the basis of features of the unit which affect its value to tenants.**

Comment: Factors to be considered would include: floor space, number of rooms, facilities in the building, building location, and other factors which analysis of the data collected by the Staff of the Guideline Board show to have a significant impact on market rents. The standards of maintenance of buildings is a factor which would be difficult to quantify for purposes of market comparison rent review. Nevertheless, a checklist to be used for ''scoring'' the maintenance standards of buildings could be developed, using the data collected by the Guideline Board Staff. See section 5.3.4.

Recommendation 12. **That either the landlord or the tenants in a complex be free to initiate a market comparison review hearing. In either case, all the units in the complex would be affected by the review. Accordingly a tenant-initiated hearing should have the support of a majority of the tenants.**

Recommendation 13. **That the market comparison rent review adjustment made by a Review Officer bring the rents for units in the residential complex under review into line with average rents for similar units in comparable complexes.**

Comment: The order might either increase or decrease rents in the complex being reviewed. In some cases, the rents for units of one type would be increased while those for other types would be decreased. The units of each type (e.g. bachelor, one bedroom, etc.) would have their rents compared with the rents of units of the same type in other complexes independently; hence, the percentage adjustment for the rents of one type of unit could differ from the adjustments for other types of units in the complex.

Recommendation 14. **That where there has been a market comparison review hearing, the resulting rent increase (or decrease) in rent for each unit in the complex be as ordered by the Review Officer by combining the guideline rate of increase for the year with any market comparison review adjustment, subject to the rent adjustment being phased-in.**

Comment: The ordered rents would be the fair market rents for the units. Future application of the guideline rate would maintain fair market rents for those units subject to Recommendation 8 provided there was no major change in the value of a unit, due to major renovation or lack of maintenance.

Recommendation 15. **That the rent ordered under a market comparison rent review hearing take effect at the termination of the current lease or if there is no lease at the commencement of the next rental unit year.**

Comment: The rental unit year is defined in Volume 1 as the 12-month period commencing with the effective date of a rental unit's last rent increase.

Recommendation 16. **That values for variances be established to facilitate the comparison of rents in units which are not similar. Variances should be set by the Guideline Board on the basis of the average per unit cost as determined by analyzing the data on surveyed landlords. The standard variances should be the subject of submissions at the annual fair return rent control hearing.**

Comment: Variances should be established for all features used for determining whether buildings and units are similar, as set out in Recommendation 11. The use of the tables would be required in cases where there are no closely similar complexes or units to serve as the basis for comparison, as discussed in section 5.3.4.

It is anticipated that the Staff of the Guideline Board would prepare a schedule of variances for use by Review Officers. The proposed schedule would be presented to the Guideline Board and could be the subject of submissions by either landlord or tenant representatives. The Guideline Board would make a determination setting the variances to be used in market comparison rent review hearings.

Recommendation 17. **That the units in a complex which had undergone a market comparison review hearing be the subject of a subsequent review hearing only if a Review Officer is satisfied there has been material change in their value relative to other units in the market.**

Comment: Normally, units and buildings which are comparable at one time will continue to be comparable for many years. Hence, if similar rents are set for similar units because they are subject to the same guideline rate, their registered rents (see Recommendation 21) will continue to be similar. In that event, subsequent market comparison review hearings should not be necessary.

In some cases, however, a building or some units in a building, may be renovated so that they are no longer comparable to units which were previously used for determining similar rents. It is also possible a landlord will let a building deteriorate more than is normal. In such cases, a subsequent market review hearing may be justified to reduce rents.

Recommendation 18. **That there be a provision for adjustment by a Review Officer of the rents in a complex which are out of line with the rents for similar units in the same complex, referred to as a single building rent review.**

Comment: The purpose of single building review is to equalize rents of similar units in the building. A single building review would be transformed into a market comparison review upon application by the landlord or a majority of the tenants in the building. The Review Officer in a single building rent review hearing has authority to increase or decrease rents so that similar rents are paid for similar units in the complex. If necessary, rents would be set by the application of the tables of variances published by the Guideline Board. Single building rent review is the appropriate method of dealing with cases of alleged gouging.

Recommendation 19. **That either the landlord or one or more tenants be entitled to initiate a single building review hearing. If the landlord initiates a single building rent review, the rents for all units in the building should be reviewed. If it is initiated by a tenant or tenants, only the unit(s) occupied by the particular tenant(s) will be affected.**

Comment: An individual tenant household should have the right to have its unit reviewed to protect it against gouging and economic eviction.

Recommendation 20. **That rent or rents established by a single building review hearing be superseded by the rents ordered under a subsequent market comparison review.**

Recommendation 21. **That the rent registry record:**
1. the actual rent being charged for a unit at the time the FMR system is introduced, 2. the registered rent and 3. the anniversary date for rent increases.

Comment: The rent registry is discussed in section 5.6. The registered rent would be the rent being charged at the time the FMR system is introduced, as adjusted annually by the guideline rate. In the event a market comparison or single building review hearing is held, the registered rent would be the ordered rent, adjusted annually by the guideline rate. This information would be reported to the registry office accompanied by a sworn copy of the landlord's rent roll. The Review Officer has authority to investigate the validity of information supplied by the landlord.

Recommendation 22. **Where the rents for units in a residential complex have not been ordered under a market comparison rent review hearing, a landlord and tenant be permitted to negotiate a rent which could be in excess of the registered rent.**

Comment: The rationale for allowing rents to be negotiated between landlords and tenants is discussed in section 5.5. Essentially, negotiation serves as a simple substitute for a market comparison rent review hearing.

The negotiated rent should be reported to the registry by the landlord. This is required so that if a market comparison review hearing does take place, the Review Officer will have ready access to information on the actual rent being paid for units considered to be similar. The negotiated rent would subsist, however, only between the landlord and the tenant with whom it was negotiated and only for the duration of the current lease.

Recommendation 23. **That under the FMR system, rebates for overpayment of rents can be claimed when the actual rent charged and paid exceeds the registered rent for a unit which has been the subject of a market comparison review hearing.**

Comment: A function of FMR regulation is to serve as a transition from the present depressed rent levels to the fair market rent level. The rate of transition, however, should not exceed the rate allowed by the scheme. The registered rent will be on record in the rent registry and available to a tenant upon inquiry. Should an inquiry reveal that the rent being charged is greater than the registered rent two consequences would follow. The tenant would be entitled to reduce the rent being paid and would have the right to sue in small claims court for recovery of any excess rent paid. The other consequence would be that an official of the registry office would have the responsiblity of charging the landlord under an applicable penal provision of the legislation if such action is deemed warranted.

In the case of a unit which has not been the subject of market comparison rent review, negotiation is allowed per Recommendation 22. In that event no rent which was agreed to would be illegal; hence, no rebate could be claimed.

The right of tenants to claim rebates for alleged illegal rents predating the introduction of the FMR system would be governed by the provisions of the 1986 Act.

Recommendation 24. **That new residential rental complexes be exempt from rent regulation for five years after the first unit is rented.**

Comment: The rationale for exempting new units is discussed in section 5.8.2.

Recommendation 25. **That the FMR system of rent regulation be accompanied by a shelter allowance program, which will ensure that households which do not have access to socially assisted housing and cannot pay fair market rents will be able to afford decent, adequate housing.**

Comment: Budgetary programs designed to assist low-income households are an essential part of an overall integrated rental housing policy. The private market cannot supply adequate housing suitable to the needs of those households at rents they can afford unless the investor/landlords or the tenants or both are subsidized. Socially assisted housing in the form of public, socially integrated, non-profit, and cooperative housing can provide relief for only a fraction of the households which need assistance. It does nothing for those households who are not housed in assisted units either because such housing is in short supply or because it is not suitably located. Until a comprehensive income support program is available to assist those households, a shelter or housing allowance program is the only means of resolving their affordability problem. Such a program should be made available to all tenant households who cannot afford market rents.

When shelter allowances are implemented in conjunction with the FMR system of rent regulation the objection that they will lead to an increase in rents, leaving tenants no better off, need not be a concern. With regard to the cost of a housing allowance program, it should be noted that implementing the FMR system, which is a policy which will attract private investment back into rental housing for tenants who can pay market rents, will free up government funding to be used for the benefit of tenants who are not in that fortunate position.

The level of assistance would be determined by the budgetary constraints on government, but sufficient funds should be allocated to the program at least to offset the impact of the introduction of the FMR system on the rents of low-income households. A rough estimate of that minimum allocation would be $62-million annually. That estimate is based on Slack's (1985, p. 23) estimate of the maximum amount of the aggregate annual rent reduction due to rent regulation ($377-million, as reported in section 1.3.1 of this Report) and Stanbury and Vertinsky's (1986, p. 6-112) estimate of the proportion of the total benefits going to the 44 per cent of tenant households with lowest income (16.5 per cent of total benefits to households with income under $15,000). Hence, 16.5 per cent of the $377-million benefit, or $62-million would be adequate to provide a shelter allowance which provides benefits that at least equal the benefits of the current restrictive rent regulation system. In fact, since many low-income households are in socially assisted housing and therefore would not receive a shelter allowance, a shelter allowance program on that scale should provide more substantial benefits to recipient households.

Appendix A

Ontario's Residential Rental Dwellings, Landlords and Tenants

Introduction

1. The Rental Housing Stock

This Appendix, which is divided into three sections, provides an overview of Ontario's rental housing stock, landlords and tenants. The first section provides background data on the rental housing stock, ranging from the geographical distribution and composition of structural types of rental dwellings, to changes in the rental stock arising from the market demand for rental housing, the presence of socially assisted rental units and the level of demolitions and conversions taking place in the rental market. The second section provides an overview of Ontario's landlord population. The composition of landlord ownership, landlords' motivations for investing in residential real estate, investment and income sources of landlords are examined in light of the limited information available on these topics. The final section profiles the tenant population and covers such topics as current and future population trends and projections, and the composition of renter households by household type, income and age.

1.1 Distribution of Rental Stock

In 1981, 37 per cent of Ontario's occupied dwellings were rentals and provided accommodation for more than one million households.[1] In terms of geographical distribution, 93 per cent of the province's rental dwellings were in urban areas identified as population centres of 1,000 or more having a density of 400 or more persons per square kilometer. In contrast, only 16 per cent of the

1. Unless otherwise noted, data are from the 1981 Census and Pringle (1986). The 1981 Census contains the most recent data available.

dwellings in rural areas were rentals. A further breakdown shows that 74 per cent of rental units were located in the province's 10 CMAs. These urban areas of 100,000 people or more encompass the cities of Hamilton, Kitchener, London, Oshawa, Ottawa, St. Catharines-Niagara, Sudbury, Thunder Bay, Toronto and Windsor.[2]

Of a total rental stock of 1,091,000 units, 837,000 units (or 77 per cent) were subject to rent regulation in 1981. This left 254,000 units or 23 per cent of the rental stock in the exempted sector. In 1981, the average monthly rent for a pre-1976 unit was $277; for a post-1975 unit, $326 (Pringle, 1986, Table 4.3, p. 181).

The distribution of the rental housing stock by structural type indicates that in 1981, 67 per cent of the province's rental stock was apartment units.[3] Forty per cent of the rental stock was in apartment buildings of five or more storeys;[4] 27 per cent of the stock was in low-rise apartment buildings. The balance (33 per cent) were single and semi-detached houses, duplexes and row houses.[5]

Table 1 summarizes the distribution of the rental stock by structural type. Average rent levels also are recorded.

More recent data[6] indicate that almost three renters in 10 occupy single family dwellings and more than half of these are single detached houses. Ten per cent of single detached houses, 38 per cent of attached houses, 65 per cent of duplexes and more than 90 per cent of apartment units are rented. Pringle (1986, p. 73) estimates that 39 per cent of all condominiums in Ontario may have been rented in 1981. The City of Toronto Planning and Development

2. Within the CMAs, there is considerable variation in the split between ownership and rental housing. For example, Ottawa had the highest proportion of occupied rental stock at 49 per cent, Toronto had a proportion of 44 per cent and St. Catharines had the lowest proportion at 29 per cent.

3. According to the 1981 Census Dictionary by Statistics Canada, an apartment refers to a dwelling unit in a triplex, quadruplex or a dwelling unit in a nonresidential building or in a house that has been converted or a dwelling unit in a high-rise apartment building (p. 90).

4. Between 1961 and 1981, the majority of the additions to the rental stock were high-rise apartments. Before 1961, less than 20 per cent of the stock of rental apartments was located in buildings of five or more storeys.

5. Distinctions between privately initiated and socially assisted housing are made in section 1.4. Socially assisted housing, as defined by MMAH (1983, pp. 56-57) includes geared-to-income, non-profit and co-operative accommodation.

6. Muller (1986) uses 1985 census estimates up to the end of the first quarter and assumes that the tenure split by structural type was the same in 1985 as in 1981. See Tables 2.2 and 2.3, p. 32.

TABLE 1: Distribution of the Occupied Rental Stock by Structural Type, Ontario, 1981

Structural Type	Rented Units (000's)	Percent (%)	Average[1] Monthly Rent
All Types	1,091	100.0	303
Single Detached	163	14.9	316
Single Attached[2]	147	13.5	359
Duplex	50	4.6	283
Apartments:	726	66.5	290
5 plus storeys	434	39.8	311
4 or less storeys	292	26.8	260
Mobile	4	0.3	230

NOTES: 1. Excludes rented farm dwellings; includes average payment for heating, water and other municipal services not included in monthly cash rent.
2. Includes doubles, rows and dwellings attached to non-residential buildings.

SOURCES: Derived from Statistics Canada, 1981 Census; and CMHC, *Canadian Housing Statistics* as found in Muller, 1986, Table 2.1; Rent data fom unpublished Census data.

Department estimates that 30 per cent of all condominiums in the City of Toronto were rented in 1983.[7]

Considerable attention has been focussed on the distinction between high-rise and low-rise apartment buildings. Low-rise buildings are distinguishable from other forms of rental accommodation in that these buildings are "typically older than average, located in the central areas of large cities and owned by individuals or corporations with small portfolios...and the operating costs of these buildings may form a larger than average fraction of gross revenues." (Muller, 1986, p. 37) Redevelopment pressures on low-rise rental buildings have increased due to their age, low rentals and central locations. Peter Barnard Associates (1985) estimates that eight per cent of the City of Toronto low-rise stock, as it was in 1977, was either vacant (three per cent) or demolished (five per cent) by 1984. The vacant units, according to that study, were "likely awaiting demolition, conversion or luxury renovation." (p. 29) A recent study for the Ministry of Municipal Affairs and Housing (Ekos, 1985a) concluded that at least 30 per cent of the low-rise rental stock in Hamilton, Ottawa and Toronto was likely to be "in jeopardy" over the next 10 years.

Another important feature of low-rise apartment buildings, according to the Barnard study, is that they are "the principal source of non-subsidized

7. City of Toronto Planning and Development Department, Report to the Neighbourhoods Committee, *Condo Monitor '84 — Further Report*. Jan. 23, 1985.

housing for low-income households.'' (p. 1.10) A survey of low-rise buildings in Ottawa, Toronto and Hamilton found that 41 per cent of the tenant households in these buildings had incomes below the 1984 poverty lines for the appropriate household size.[8] Losses to this low-rise, low-income rental stock have occurred.

Klein and Sears (1983, v.4.1, p. 13) conclude that the City of Toronto lost 1.2 per cent of its rental housing stock through demolition and conversion to condominiums during the period 1976-80.[9] This study also notes a net loss of 9,400 units (or 3.6 per cent of the occupied dwelling stock) in the owner-tenant category between 1976 and 1981.[10]

According to Muller (1985, p. 44), this category is frequently the source of low income rental accommodation. More recent data by Comay (1984, p. 25) claim that the existing stock of moderate rental apartments is at some risk, with an estimated loss of 7,500 medium or moderate rental units over the period 1980-84. This loss is said to have occurred ''through conversion to ownership housing, luxury renovation, prospective demolition or other reasons.''

High-rise apartment buildings tend to be newer, located in large urban centres and have higher than average rents. In 1981, approximately 90 per cent of the units in high-rise buildings were rentals and provided accommodation for more than 430,000 households.[11] The remaining 10 per cent were primarily owner-occupied condominium units.

The remaining rental stock consists of various types of single attached and single detached units. The category of single attached includes doubles, row housing and dwellings attached to non-residential buildings. It represented 13.5 per cent of the occupied rental stock in 1981 (see Table 1).

Single-detached houses have been and are still the most common type of housing and represented 54.4 per cent of the province's total housing stock in 1981 (Muller, Table 2.1). Although less than 10 per cent of single-detached houses were rented, this category still provided 15 per cent of Ontario's occupied rental units.

8. The 1984 poverty lines set by Statistics Canada for a one and two person household in Ottawa or Toronto was $9,839 and $13,981 respectively (Peter Barnard Associates, 1985, p. 1.10).

9. Muller (1985, p. 44) adds that although this loss of units was more than offset by new additions to the rental stock, these may have been larger or more expensive units.

10. Owner-tenant dwellings is not a census category. These dwellings consist of dwelling units in which the tenants' quarters are not self-contained.

11. Muller (1986, Tables 2.1, 2.2). Klein and Sears (1983) noted that during the period 1961-1981 the vast majority of additions to the rental stock were high rise apartments. Less than 20 per cent of the pre-1961 stock of rental apartments was located in buildings of five or more stories, while in 1981 40 per cent of Ontario's rental housing stock was comprised of units in buildings of five or more stories. (Vol. 1, p. 5).

Between 1961 and 1971, both the rental and ownership sectors grew rapidly. The 1981 Census reports that 60 per cent of the 1981 rental stock was built between 1961 and 1981, compared to 46 per cent of the ownership stock. Over this period, annual increases in the socially assisted rental stock (reviewed in the next section) averaged 14 per cent while the increases in the private rental stock averaged 3.5 per cent. MMAH (1983, p. 19) notes that overbuilding occurred between 1972-1973, with rental starts of about 42,000 units per year while demand was about 26,000 units per year. What followed was a period of inventory absorption (1973-1975), as shown in Figure 1. Between 1976 and 1982, rental starts were low compared to 1973 figures but grew as a percentage of overall starts because ownership starts continued to fall through 1982. This trend was reversed in 1983 as rental starts remained relatively constant while ownership starts rose substantially. By 1984, estimated rental starts were down to 9,400 units, representing 19.5 per cent of all starts compared to the 1976 to 1984 average share of 26.7 per cent.[12]

1.2 Socially Assisted Housing

The size of the socially assisted rental stock has had a direct impact on the stock of rental units. Existing data[13] show that socially assisted housing has increased its share of the total rental stock from 2.3 per cent in 1961 to 12.7 per cent in 1981. Just over half of the 1981 total (6.9 per cent) was accounted for by public housing, in which all units were originally reserved for subsidized renters. Most of the remaining units were accounted for by limited dividend units (2.4 per cent) and the non-profit and co-operative housing programs (2.3 per cent). In terms of actual numbers, by the end of 1984, there were approximately 105,000 limited dividend and Ontario Housing Corporation (OHC) public housing units, 41,600 non-profit units and just over 12,000 co-operative units.[14] The non-profit and co-operative housing programs differ from the others in allocating a smaller portion of their units to subsidized renters.[15]

With respect to the share of net additions to the rental stock, socially assisted housing has played a significant role.[16] Table 2 shows that between

12. Ontario Ministry of Housing. *Ontario Housing Market Quarterly Review*, September, 1985, p. 2.

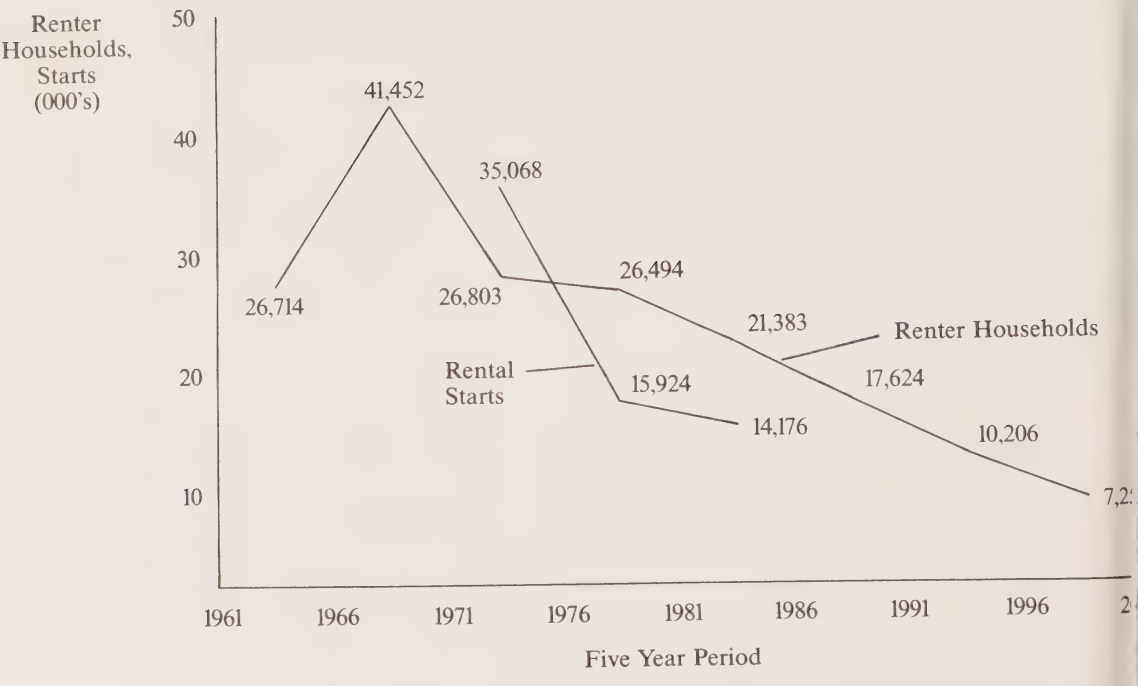
13. Muller (1986, Table 2.8A).

14. Pringle (1986, Table 2.14).

15. See the discussion on income mixing in Chant (1986, pp. 364-367).

16. The net change to the rental stock over a period of time equals the difference between additions to the stock from such sources as new construction (privately and publicly initiated) conversions from ownership housing and conversions from non-residential to rental residential and rental stock losses due to conversions to ownership and non-residential uses and demolitions.

Figure 1: **Average Annual Increase[1] in Renter Households and Rental Starts, Ontario, by Five Year Periods, 1961-2001**



NOTE 1: Annual averages for the five year periods are plotted at the mid point of the period.

SOURCE: Renter households 1961-1981, derived from Statistics Canada, Census as found in Foot, 1986, Table A1.5; 1986-2001, projections based on 1981 Census and Population Projections derived from the Census by Stamm Research Associates as found in Foot, 1986, Table A 6.2.1.
Rental construction starts based on CMHC, Canadian Housing Statistics, various years, tenure split estimates (and forecasts for 1985, 1986) from MMAH, as found in Pringle, 1986, Table 2.19; also, Stanbury and Vertinsky, 1986, Table 6-20 for 1971, 1972.

TABLE 2: Contribution of Socially Assisted Housing to the Growth in the Rental Stock, Ontario, 1961-1981

Program	1961/66	1966/71	1971/76	1976/81
Public Housing	5,472	30,558	34,588	635
Limited Dividend	2,158	3,317	12,706	3,418
Non-Profit	1,858	725	1,707	12,738
Co-operative	0	0	462	4,594
Other Programs	0	6,598	829	5,284
Total Socially Assisted	9,488	41,198	50,294	26,669
Total Occupied Rental Stock	133,570	208,060	133,220	132,470
Socially Assisted as Percentage of Total	7.1	19.8	37.8	20.1

NOTE: Hostel units are excluded.

SOURCE: Derived from estimates supplied by Field Operations, MMAH; as found in Muller, 1986, Table 2.8B.

1961 and 1966, socially assisted housing accounted for only 7.1 per cent of the net increase in the rental housing stock. This increased to 19.8 per cent between 1966 and 1976 and to 37.8 per cent between 1971 and 1976.

The increase in socially assisted units was reduced to 20.1 per cent of the total increase between 1976 and 1981, a level similar to that observed between 1966 and 1971. Since 1981 total starts have declined; however, socially assisted starts have increased. The portion of total housing represented by socially assisted housing likely will rise again (Muller, 1986).

The data reported above do not include allowances for individuals and families who rent rooms or suites in private homes, but who do not constitute households according to Census definitions. These are boarders and lodgers who comprise a small segment of the total renting population but are often the ones with the lowest income and the most in need of assistance.[17] Based on 1981 Census data, Jaffary (1984) estimates that about 80,000 people form Ontario's core population of boarders and lodgers. Part of this group's housing needs are met by 10,000 socially assisted hostel beds.

17. COIRT (1984, Vol. 1, Ch. 15) discusses the position of boarders and lodgers with respect to rent review and security of tenure. See also Jaffary (1984).

2. Ontario's Landlord Population

2.1 Composition of Landlord Ownership

The MMAH survey[18] in 1980 indicated that 81 per cent of the landlords surveyed owned only one building (see Table 3). Twenty-eight per cent (1,607) of the buildings surveyed were owned by individuals while 33 per cent (1,906) were owned by corporate landlords. The survey also indicated that 62 per cent (48.0 plus 13.5) of units were owned by landlords who have one or two buildings, compared to 25.6 per cent (3.6 plus 22.0) of units owned by landlords owning five or more buildings. Seventy-two per cent of units surveyed were owned by corporate landlords. The number of corporate owners with large portfolios (i.e. owning five buildings or more) was small (2.2 per cent) but the number of units (102,615) represented about 23 per cent of units in the buildings surveyed.

2.2 Landlord Motivations

The variation in landlord ownership of the rental stock has prompted several authors to distinguish between the professional, typically corporate, landlord and the "amateur" landlord.[19] The distinction stems from varying factors motivating investment in residential rental housing. For the professional, corporate landlord the main motivation for investing in this sector is purely financial; that is, they expect to earn a net return on investment that at least matches alternative opportunities involving similar risk. For the "local-amateur" landlord, the motivations are not well articulated and are complex, although they too are motivated primarily by financial considerations. Ownership of rental housing is an investment.

In a recent survey of small landlords Ekos Research Associates (1985b)[20] asked landlords to rate the relative importance of various potential motivations underlying their current property management decisions. For 84 per cent of landlords, ensuring steady long term earnings was considered important. Containing or reducing operating costs was rated the second most important management goal by 80 per cent of landlords. Increasing long term equity was rated as important by 78 per cent. Reducing or minimizing tenant turnover,

18. Teela Market Survey, 1980. See MMAH, (1983, Tables 6 and 7, pp. 16-17). This analysis was based on a survey of both controlled and uncontrolled rental apartment buildings containing more than six units in Durham, Halton, Hamilton-Wentworth, Metro Toronto, Ottawa-Carleton, Peel and York regions. The survey covered 5,778 buildings, containing 435,174 units, or approximately 40 per cent of the total 1981 rental stock in Ontario.

19. Stanbury and Vertinsky (1986, p. 4-70 to 4-72) use this typology which was first observed by Krohn et al. (1977).

20. This particular survey underrepresents owners of property with less than six units, landlords in rural areas and landlords who have recently purchased or sold properties.

TABLE 3: Ownership Type by Number of Buildings, 1980[1]

Ownership Type	Portfolio Size (Number of Buildings)						Total	Percent of all Buildings
	One	Two	Three	Four	Five	Six +		
Corporate[2]	1,405	240	108	51	28	74	1,906	32.99
Husband-Wife[3]	924	59	14	5	4	2	1,008	17.45
Partnership	785	57	10	4	2	8	866	14.99
In-Trust	162	20	6	3	2	2	195	3.37
Individuals	1,235	157	194	9	8	4	1,607	27.81
No. Companies[4]	141	17	4	2	1	1	166	2.87
Other	24	3	0	0	0	3	30	0.52
Total	4,676	553	336	74	45	94	5,778	100.00
Percent of all Buildings	80.93	9.57	5.82	1.28	0.78	1.63	100.00	—

NOTES: 1. For buildings containing six or more units located in the municipalities of Durham, Halton, Hamilton-Wentworth, Metro Toronto, Ottawa-Carleton, Peel and York.

2. The distribution for corporate owners is treated as an estimate since some owners use more than one corporate name.

3. Since some partnerships are probably also husband and wife, these two categories are not necessarily mutually exclusive.

4. Numbered companies.

SOURCE: Teela Market Survey, 1980; as found in MMAH, 1983.

obtaining a high annual income and maintaining the building for resale were important for 60 to 70 per cent of the landlords. Table 4 summarizes the findings of the survey.

Ekos (1985a) did a similar analysis for the Ministry of Municipal Affairs and Housing but focussed only on the low-rise rental sector.[21] This survey identified a high degree of heterogeneity among low-rise landlords in terms of their background characteristics, portfolios, motivations, management styles and future intentions. The common motivating factor behind acquiring rental residential property is long term investment (95 per cent). Thirty-four per cent acquired the building as their principle source of annual income and 28 per cent acquired it for its redevelopment potential.

A closer examination indicates that motivations for acquiring the property vary with the type of owner. Partnerships (which include partnerships with relatives and investors) are least likely to have purchased the property as the principal income source while corporations and numbered companies are most likely to have purchased the property for its redevelopment potential. Individuals are most likely to have purchased the property to build up their equity over the long term as a form of pension plan (Ekos, 1985a, p.98).

Ekos (1985a) also found that the management practices of small landlords who own the majority of units in the low-rise rental housing stock differ from those of the larger owners, who tend to be corporations. One important dif-

TABLE 4: Ratings of Importance of Motivations Underlying Management Decisions

	Percentage Reporting it as Important	Mean Score on 1 to 7 Rating Scale[1]
Ensure steady long term earnings	83.9	2.1
Contain or reduce rising operating costs	79.7	2.2
Increase long term equity	78.3	2.4
Reduce or minimize tenant turnover	68.4	2.8
Obtain high annual income	59.5	3.1
Maintain building for resale	61.0	3.2
Use building for financial leverage	33.4	4.6

NOTES: 1. On the seven point scale, 1 was extremely important and 7 extremely unimportant. The percentage who report it is important consists of the collapsed 1 to 3 segment of the scale.

SOURCES: Ekos Research Associates, 1985b, Table 3.11.

21. The survey participants were from the urban areas of Hamilton, Ottawa and Toronto.

ference identified is the absence of formal written budget plans for their buildings. Approximately 63 per cent of all low-rise owners surveyed had no such plans and this also extended to record keeping.

2.3 Investment and Income Sources of Landlords

Little empirical data have been collected on the sources of income of landlords.[22] Ekos (1985b) did find that the majority of survey respondents (193) have a large proportion of their total investments in rental residential real estate. Two-thirds have 60 per cent or more of their total investments in rental real estate while 32 per cent have all their investments in this market.

Ekos (1985b) asked what percentage of total income was provided by the 1984 net rental income from their buildings. The mean was 18.3 per cent. Of those who had a positive net rental revenue (61 per cent), net revenues are an average 30 per cent of income (p. 28). Landlords were not asked to specify their other sources of income. Campbell Sharp (1985, p. 7) indirectly provided some insight into the income sources of small landlords. They identified a subsample population of landlords who could not be contacted after successive survey callbacks. They suggested these were likely small landlords who operate 10 or fewer units but were employed full-time in some other capacity. For this group, rental units were not a primary source of income.

3. Ontario's Tenant Population

3.1 Population Trends

The population of Ontario has grown from 4.6 million persons in 1951 to 8.6 million persons in 1981, which represents an average annual growth rate of 2.1 per cent. Central Ontario is the most populous region, accounting for more than 5.2 million persons or 62 per cent of the population by 1981.

The average annual growth rate over the period 1951-81 has not been constant over time but rather has shown a gradually declining growth rate throughout the period. The earlier years, 1951-66, recorded above-average growth while over the period 1976-81, the average annual growth fell below one per cent per annum.[23]

The dominant influence behind this growth pattern has been the impact of the baby boom generation over this period. Rising fertility rates over the 1950s led to a peak of just under four children per woman in the early 1960s,

22. A review of the principal sources of data on rates of return to residential rental investments is contained in Appendix E.

23. Foot (1986, p. 25).

followed by a decline in fertility rates to a below replacement level of around 1.65 children per woman by the early 1980s. This situation resulted in a rapid growth in the pre-working age group (0-14) during the 1950s. Over the early 1960s, this situation gradually reversed as the baby boomers reached labour force age.[24]

Similarly, the numbers of post-working age elderly (65 years and over) in the province rose over the period 1951-1981, with the proportion of elderly rising since the mid-1960s. Of prominence has been the rapidly increasing growth rate in the number of elderly over the 1970s.

The growth pattern over the last three and a half decades signifies an aging population — a declining proportion of young and an increasing proportion of elderly. Analysis by Foot (1986, p. 29) indicates that by 1981 in Ontario, 22 per cent of the population were pre-working age young and 10 per cent were post-working age elderly, leaving 68 per cent of the population at a working age. As expected, continued population aging will reduce the proportion of young and increase the proportion of elderly in the years to come. More recent population estimates by age and region confirm this aging trend. By 1983, the population of Ontario had grown to more than 8.8 million persons with 62 per cent residing in Central Ontario. The proportion of pre-working age young had declined to 21.2 per cent while the proportion of post-working age elderly had increased to 10.4 per cent (Foot, Table 2.5, p. 30).

3.2 Renter Households

The number of households in Ontario almost doubled from 1.64 million in 1961 to near three million in 1981, which represents an average annual growth rate of 3.0 per cent. In 1961, Central Ontario accounted for around 59 per cent of households; by 1981, this region accounted for more than 62 per cent of households.

According to the 1981 Census, there were 2.4 million people housed in rental accommodation in Ontario. In terms of households, just over one million or about 37 per cent of the three million households rented their accommodation. Of the renter households, 15 per cent were headed by females and nearly 22 per cent were headed by males. For both sexes, the life cycle pattern indicates that the rental proportion peaked in the 25 to 34 age group, declined over the middle ages and rose again in retirement (see Foot, Tables 4.1-4.2, p. 107).

The choice of dwelling structure by households confirms this life cycle pattern. Of those households (57 per cent) which were in single detached dwellings in 1981, less than three per cent were headed by persons under 25

24. Foot (1986, pp. 27-28).

years of age and only 22 per cent by persons under 35 years of age, whereas for those households (29.3 per cent) which were in multiple unit dwellings,[25] 15.4 per cent were headed by persons under 25 years of age and 43.6 per cent were headed by persons under 35 years of age. In 1976, 91 per cent of single detached dwellings were owned and 86 per cent of multiple unit dwellings were rented.

The breakdown of rental and owner-occupied headship rates (the percentage of the population 15 years of age and over that headed households) in Ontario between 1961-1981 provides further support for the life cycle hypothesis.[26] First, owned headship rates (27.9 per cent in 1981) tend to be higher than rental headship rates (16.2 per cent in 1981), reflecting the fact that most households in Ontario own their house. Second, rental headship rates are higher than owned headship rates in the younger age groups as expected since it usually takes some time to earn enough to afford a house. In 1981, 69.3 per cent of rental households were headed by persons aged 15 to 34 while 53.8 per cent of owned households were headed by persons aged 15 to 34. Third, female headship rates[27] increased dramatically first in rental housing over the 1960s (from 4.1 per cent in 1961 to 7.4 per cent in 1971) and subsequently in both rental (12.9 per cent in 1981) and owned housing (9.6 per cent in 1981) over the 1970s. Foot (1986, Table 3.14, p. 88) suggests that more than one-third of all households in Ontario could be headed by females by the year 2001.

The composition of renter households in Ontario is different from owner households. According to 1981 Census data, non-family households (defined by Statistics Canada as those composed of either one person or two or more unrelated persons) accounted for 44 per cent of all renter households as opposed to 13 per cent of all owner households. Two-parent families, with and without children, accounted for 44 per cent of all renter households versus 79 per cent of all owner households. A noticeable observation is that the ''conventional'' family of a husband, a wife and children accounted for 54 per cent of owner households but only 22 per cent of renter households. The proportion of lone-parent families and ''other'' types of households which are renter households is relatively small (12 per cent) but larger than their proportion of owner households (8 per cent). Households with no children accounted for a larger proportion of renter households than of owner households.

25. This includes duplexes and all apartments.

26. The data on headship rates are from Foot, 1986, Tables 3.8, 3.9, pp. 67-68.

27. Until recent years the male was traditionally designated as the ''head'' of the household. This is no longer the case since more females are establishing their own households.

The age distribution indicates that in 1981, 47 per cent of all renter households were headed by a person less than 35 years old compared to 21 per cent of owners. Thirty-five per cent of renter households had heads aged 35 to 64, compared to 62 per cent of owners. Renter and owner households alike had fewer than 20 per cent of their heads aged 65 or more. Figure 2 summarizes the data on renter households by type and age of head in 1981.

3.3 Renter Household Incomes

The distribution of incomes among renters suggests many households rent because they cannot afford to own. Based on Census data, the 1980 median income for non-farm renter households in Ontario was $15,500, compared to a figure of $22,600 for all households in Ontario, including renters and owners.[28] Family households in rental dwellings tend to have much lower incomes than family households who are owners. In 1980, the median income for renter family households in Ontario was $19,200 compared to $26,100 for all family households. Table 5 provides data on rents and incomes for renter households in Ontario and the 10 CMAs in 1981.

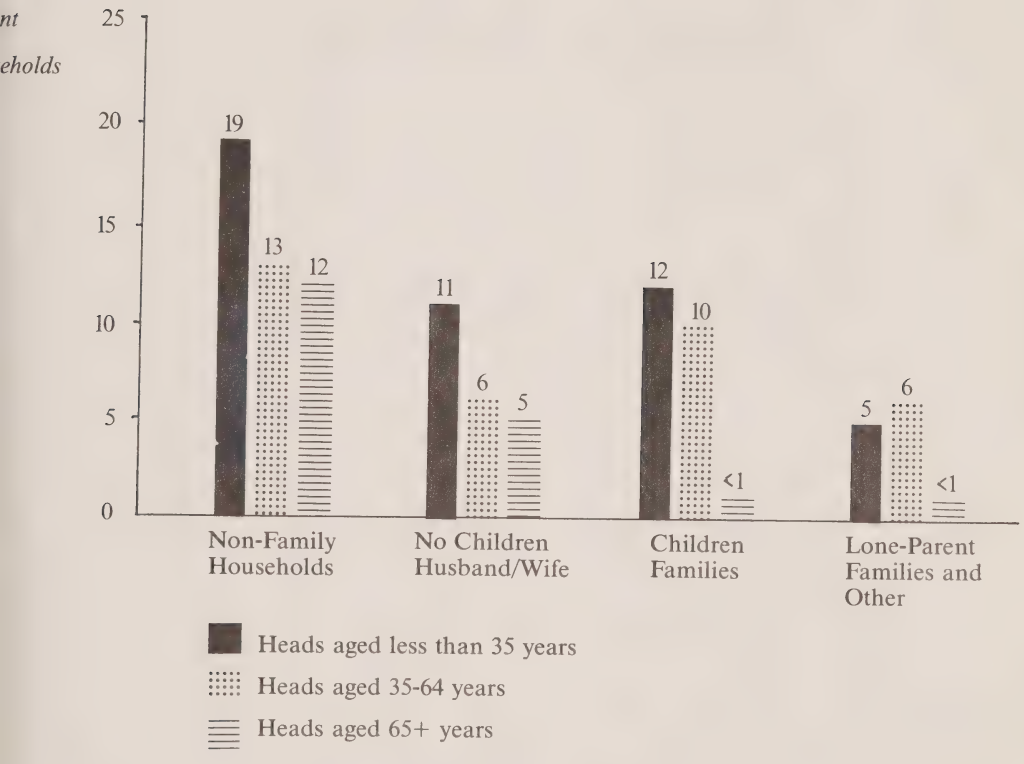
Incomes among both family and non-family renter households are widely distributed. According to Clayton (1984, p. 69), in 1980, 43 per cent of all non-family renter households had incomes of less than $10,000, while only 12 per cent had incomes above $25,000. Almost one-third of renter family households had incomes of $25,000 or more while 21 per cent had incomes of less than $10,000 in 1980. Table 6 shows a breakdown of 1981 family incomes in Ontario Housing Corporation geared-to-income housing.

3.4 Household Projections

Household projections should be regarded as illustrative since they may vary drastically depending on the data manipulations applied and on the assumptions used in the projections. Foot's analysis of future households reveals a noticeable decline in household growth to one per cent over the next 20 years when compared to the last 20 years, during which annual growth averaged more than three per cent. This result was obtained with two alternative assumptions considered in his study: 1) headship rates remain constant at 1981 levels, or 2) headship rates rise by the same proportionate amount over 1981-2001 as during the period 1961-81. For the constant headship rate alternative, the projected average household size for 2001 is 2.90 persons whereas for the

28. Clayton (1984, p. 68) suggests that the lower median income among renters may be partially explained by the high proportion of non-family households in rental accommodations since non-family households tend to have relatively low incomes.

Figure 2: **Renter Households by Type and Age of Head, Ontario, 1981**



SOURCE: Statistics Canada, 1981 Census. As found in Clayton, 1984, Figure 2.

TABLE 5: Rents and Incomes for Renter Households, Ontario and CMAs, 1981

	Median[1] Annual Income	Average[1] Annual Income	Average Gross[2] Monthly Rental Payment	Average Rent-to-Income Ratio
Canada	15,171	17,587	296	20.2
Ontario	15,483	17,752	303	20.5
Hamilton	14,838	16,784	278	19.9
Kitchener	14,706	16,372	274	20.1
London	13,901	15,965	288	21.6
Oshawa	17,471	18,488	314	20.4
Ottawa	16,905	19,406	329	20.3
St. Catharines-Niagara	12,362	14,991	261	20.9
Sudbury	14,312	15,751	257	19.6
Thunder Bay	14,228	16,686	294	21.1
Toronto	17,150	19,634	340	20.8
Windsor	12,134	14,898	269	21.7
Coefficient of Variation[3]	0.13	0.10	0.10	0.03

NOTES: 1. Refers to 1980 pre-tax income.

2. Refers to mid-1981 rents.

3. Coefficient of variation is the standard deviation divided by the average.

SOURCE: Statistics Canada, 1982, Census, 93-942; as found in Pringle, 1986, Table 3.8.

TABLE 6: Ontario Housing Corporation Geared-to-Income Housing, Average Annual Incomes of Family Tenants By Income Source and Household Size, 1981

Source		2 Persons	3 Persons	4 Persons	5 Persons	6 Persons	7+ Persons	All Income Household Sizes
Social Assistance	Average Income	$ 5,272	6,269	7,015	7,617	8,299	8,975	6,205
	% of Families	39.8	31.3	18.1	7.4	2.6	0.8	100.0
Employees and Others	Average Income	$10,833	11,923	13,515	14,911	15,751	16,356	13,205
	% of Families	18.5	24.8	25.6	17.5	8.3	5.3	100.0
All of the above	Average Income	$ 6,946	8,655	10,694	13,188	13,858	15,212	9,565
	% of Families	29.6	28.2	21.7	12.2	5.3	3.0	100.0

SOURCE: Compiled from Ministry of Municipal Affairs and Housing and Ministry of Community and Social Services data on 1981 incomes. As found in MMAH, 1983, Table 37.

increasing headship rate alternative, the projected average household size is 2.22 persons. The results vary from a low of 3.4 million households to a high of almost 4.7 million households, producing a large range of 1.3 million households (1986, pp. 80-81).

Foot's results indicate that the effect of population aging on household growth in Ontario by 2001 is substantial. A comparison of Foot's constant headship rate projection with another projection based on low fertility and medium migration (Stamm, 1985) shows the total number of projected households to rise from just over 3.5 million to about 4.1 million by the year 2001.[29] Foot comments that the aging effect adds around 600,000 households over this period which can be translated into an average annual growth rate of 1.66.

Muller (1986), like Foot, identifies important shifts in the age structure of the population as the post-war baby boomers move into middle age and are followed by the baby ''bust''.[30] Muller estimates the population in the 15-24 age group will decline by four per cent from 1981 to 1986 and will finally grow by less than three per cent from 1996 to 2001. This is in contrast to the over 65 age group, which will grow by 14 per cent to 1996 and by nine per cent to 2001 (p. 155). Most of the growth in households is expected in the 35-54 years old category where home ownership is common.

Household projections into the future indicate that the maturation of the baby boom generation will ease the pressure on rental housing markets relative to owner-occupied housing markets. Assuming the current tenure split by age remains constant, Muller estimates that renter households will eventually decline to a growth of four per cent for 1996 to 2001 (down from 10 per cent from 1981 to 1986.). Foot also estimates that the demand for rental housing will fall by 2001. Based on constant headship rates, Foot estimates that the proportion of households demanding rental accommodation will fall from 37.2 per cent in 1981 to around 34 per cent by 2001. Household projections by Muller indicate that the growth in renter households will increasingly come from a rise in older households. Non-family households and households without children will account for most of the growth in total renter households with shares of 62 per cent for the period 1981-86, 62 per cent for the period 1986-1991, 66 per cent for the period 1991-1996 and 70 per cent for the period 1996-2001.

29. See Foot (1986), Tables 3.10 and 3.11, pp. 86-89.

30. The Stamm projections referred to earlier are contained in Foot's study. Tables 4.1-4.5 in Muller (1986) show how household formation will be affected by the changing age structure, assuming that headship rates remain constant.

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Appendix B

Measuring the Gap Between Market and Regulated Rents in Ontario

Introduction

This Appendix reviews estimates of the gap between market rents and actual regulated rents in Ontario. Two particular cases are examined. The first concerns the magnitude of the gap between the actual regulated rent level and the short-run unregulated market rent level. That case provides an indication of how much rents would be likely to increase if rent regulation was removed. It is the subject of section 1. The second case, dealt with in section 2, concerns the gap between the actual rent level and the long-run unregulated market rent level. It provides an indication of the amount by which rents are being held down relative to the rent level which would have prevailed if rent regulation had never been introduced.

In a balanced market some deviations between the short-run and long-run unregulated market rent levels may arise due to unanticipated shifts in demand or other factors. However, these deviations are rarely large and it is even more rare for them to persist. In a rent regulated market, where rents are held down so that the industry return on investment is less than the competitive rate (that is, when regulation is restrictive as defined in Chapter 4), there may be a persistent shortage of rental housing. In those circumstances, the short-run unregulated rent may increase to a level substantially above the long-run unregulated market rent. The gap between the long-run and short-run unregulated market rent levels represents potential short-run excess profits which will provide an incentive for developers and landlords to find ways to circumvent the regulatory constraints to profit from the unfilled demand in the marketplace.

1. The Short-Run Rent Gap

Estimates of the short-run rent gap may be based on either actual experience or one of several indirect techniques. For direct estimates to be made it is

necessary that rent regulation be removed so that the way rents respond to prevailing conditions can be examined.[1] The experience of other jurisdictions where rent regulation has been discontinued is not relevant to Ontario at this time because the size of the rent gap depends on the prevailing economic and housing market conditions. As a consequence, estimates of the rent gap in Ontario must rely on indirect estimates which take into account the specific prevailing economic and market conditions.[2]

It is a common perception that the gap between the rent a tenant is paying and the rent that others would be willing to pay for the unit, if the landlord were to ignore the regulatory constraints, is the short-run rent gap. However, that is an over estimate of the rent gap. The rent a landlord can get for a unit, assuming the rents for all other units continue to be regulated is significantly greater than the rent that the landlord could get for that unit if all rents were deregulated. If all rents were deregulated, rents generally would increase to the short-run equilibrium level, thereby reducing effective demand. With higher rents in general, there would be a higher vacancy rate and less opportunity for those landlords who were previously not subject to controls to obtain a high rent for their unregulated unit.

There have been a number of estimates of the effect of rent control on the level of rents in the short run in Ontario. In the first (MMAH, 1982), Econalysis Consulting Services constructed a simulation model of the housing markets for the Toronto and London CMAs. The model encompassed the controlled and uncontrolled rental sectors and the ownership housing sector. On the supply side, variables included profitability, previous starts, demolitions and transfers, and various costs.[3] Variables on the demand side included household income, the inflation rate, mortgage rates, household formation by type and changes in the labour force. Given the influence of those factors, the model estimates — assuming rents were decontrolled at the beginning of 1982 — the likely short-run increase in rents. The following effects in the Toronto CMA were observed:

> Rents in the formerly controlled sector increase by about 19 per cent above the rate of inflation from 1982 to 1983, but then settle down to more moderate increases. Rents in the uncontrolled sector, on the

1. See, for example, McFadyen and Chambers (1983) on the Alberta experience.

2. The analysis in this Appendix proceeds under the assumption that the introduction of rent regulation does not increase the equilibrium rent. In other words, the effect of government actions on the perceived political risk is not taken into account.

3. As described in Stanbury and Vertinsky (1986, pp. 6-21 to 6-22).

> other hand show a somewhat lower increase from 1982 to 1983 and rates actually fall relative to inflation through 1986. (p. 30)

For London it was estimated that:

> Rents in the controlled sector would increase by 3 or 4 per cent relative to inflation in 1983, while rents in the uncontrolled sector would increase by about 1 per cent above the inflation rate . . . The rent increase on controlled units in London would return rents by early 1983 to the same level of real rent as existed at the start of 1981. (p. 38)

The difference between the two cases highlights the effect of market conditions on rent increases. In London there was:

> A much higher vacancy rate by 1979 and 1980 with the result that uncontrolled rents did not increase relative to controlled rents as competition, rather than rent review, limited increases. In addition, the over supply of rental housing units led to a fall off in starts by 1980. (p. 36)

Clayton (1984) comments on that study:

> Clearly, the inflation assumptions are now too high. Since inflation encourages homeownership this would suggest that the projections have underestimated rental demand. This would imply that the rent increases upon decontrol in the controlled units may have been underestimated . . .
>
> However, since the projections do not allow for the effect of investor confidence on housing starts, the projection of rent increases in a rent controlled environment are probably too high. Moreover, if rental starts depend to a large extent upon investor confidence, decontrol could increase starts, despite a reduction in uncontrolled rents. (p. 44)

Clayton (1984) provides some indication of what immediate rent increases could be assuming immediate decontrol occurred in January, 1985. He suggests that rents would have to increase about 25 per cent in order to reach the levels at which new units would be available. However, he says rents would not have to reach that level in order to stimulate new construction:

> With decontrol and rising real rents, investors will be able to foresee that real rents are approaching economic levels before rents actually reach that level — it can therefore be expected that some investment will occur before the intersection of average market rents for new accommodation and economic rents. (p. 59)

Increases in average real rents "would be fairly significant in the early years, especially in tight markets." He estimates:

> Average real rent increases for the country as a whole of 6-8 percent per year in 1985 and 1986 seem likely with the larger increases occurring in the previously rent controlled stock where vacancies are very low — especially in tight markets. Average real rent increases in the following years would likely be more moderate. (Ibid., p. 59)

Table 1 shows average rents paid for two-bedroom apartments in the controlled and uncontrolled sector of Ontario's CMAs. Uncontrolled rents in October, 1984, ranged from 19 per cent higher in St. Catharines-Niagara to 56 per cent in Sudbury; uncontrolled rents in the Toronto CMA were almost 40 per cent higher than controlled rents (Muller, 1986, p. 141).

For several reasons this data cannot be used as an indicator of the rent gap in the short run. As noted in Muller (1986), Stanbury and Vertinsky (1986) and Steele and Miron (1984) there may be quality differences between the two sectors. The uncontrolled units are newer or designed as luxury units or both (Muller, 1986, p. 141).

Two other factors affect a comparison of relative rents. First, the market prices of housing attributes are not directly observable. Second, housing characteristics are highly interdependent (Jazairi, 1983, p. 6). Jazairi (1983) and Fallis and Smith (1984, 1985a) developed hedonic price indices[4] wherein rent is the sum of implicit prices of various quality and service characteristics such as number of rooms, age, access to subway transportation, air conditioning, cable TV, parking and recreational facilities.[5] Various regression techniques were used to control for the interdependency factor. Once quality differences were taken into account, Fallis and Smith estimated that uncontrolled rents in Toronto in 1982 were between 14 and 29 per cent higher than controlled units of comparable quality.

4. The use of hedonic indices is extensive in analyses of housing quality and rents. See Ball (1973), Butler (1982) and Jazairi (1982).

5. Stanbury and Vertinsky (1986) review Fallis and Smith (1984, 1985a). See also Adams, Ing and Pringle (1986).

TABLE 1: Rent Levels[1] for 2-Bedroom Units, by Regulatory Status Ontario, CMA's, 1983-1984 (Current Dollars)

CMA	October 1983			October 1984		
	Regulated	Unreg.	All Units	Regulated	Unreg.	All Units
Hamilton	—	—	—	359	478	373
Kitchener	323	405	340	345	445	368
London	337	438	373	361	474	395
Oshawa	—	—	398	407	494	425
Ottawa	428	534	452	441	564	470
St. Catharines[2]	332	371	340	357	424	373
Sudbury	308	438	335	339	528	367
Thunder Bay	371	456	404	398	487	434
Toronto	427	581	453	447	618	479
Windsor	352	450	400	381	530	457
Unweighted Avg.	360	459	388	384	504	414

NOTES: 1. For privately initiated buildings containing six or more units. Based on a subsample of the rent surveys where a unit has been included in at least three consecutive surveys. 2. Includes Niagara.

SOURCES: Published and unpublished data provided by MMAH from CMHC rental vacancy surveys; as found in Muller, 1986, Table 3.5.

Jazairi (1983), in a similar analysis using different variables and a slightly different data set, found that the difference between average rents in the controlled and uncontrolled sectors was between nine and 14 per cent. He suggests the lower estimate is the better one due to the interdependency factor. (p. 26)

According to Steele and Miron (1984) much of the nine per cent difference calculated by Jazairi may be attributed to newness rather than exemption from regulation. This point is based on the "strong correlation between newness and exemption from rent review in Jazairi's data set. (Steele and Miron, 1984, note 35, p. 97)[6] Moreover, a variable reflecting length of tenure discounts is absent in both Jazairi (1983) and Fallis and Smith (1984, 1985a) "despite the well-established finding that long-term tenants on average enjoy a rent discount." (Steele and Miron, 1984, p. 45) Steele and Miron contend that since controlled units are older than exempt units and there are more controlled units, it is likely that more tenants in controlled units receive tenure discounts. They suggest the difference attributed to controls "could easily be under 9 per cent in Toronto and . . . close to zero in places outside the Toronto orbit." (1984, p. 45)

Lastly, Muller (1986), in discussing Jazairi's nine per cent differential, argues that:

6. As cited in Stanbury and Vertinsky (1986, p. 6-15).

> Even this lower estimate of the difference between controlled and uncontrolled rents should not be used as an indication of how far rents would rise under decontrol. As discussed earlier, Smith and Tomlinson (1981) have argued that in the case of dual markets, the market clearing rent will be intermediate between the controlled and uncontrolled rents. (p. 142)

Further, he notes that Fallis and Smith (1984, reviewed below) estimated for the Toronto market that the market clearing rent was in fact about midway between controlled and uncontrolled rents.[7] Controlled rents were about 11 per cent lower than market clearing or short-run equilibrium rents and uncontrolled rents about 10 per cent higher.[8] Muller concludes as follows:

> In summary, our best estimate is that, in 1984, market clearing rents on existing stock lay about 10% above the controlled rent on comparable units. Market clearing rents for new apartments would be somewhat higher, but probably below the reported average rents on the uncontrolled stock. (Ibid., p. 142)

Stanbury and Vertinsky (1986) suggest the presence of social housing units "which rent for somewhat less than the market level, has the effect of understating this measure of difference between rents in the controlled and uncontrolled sectors." (p. 6-107) Under the assumption that rents in social housing units are about 80 per cent of the market rents in the controlled and uncontrolled sectors, they estimate that quality adjusted rents in the controlled sector in 1982 were about 8.5 per cent below what they would have been in the absence of controls. Quality adjusted rents in the uncontrolled sector were about 8.5 per cent higher than in the absence of regulation.

2. The Long-Run Rent Gap

Estimating the long-run rent gap — how much higher rents would be if rent regulation had not been introduced in Ontario — is much more difficult than

7. The reason that the gap is less than the difference between the controlled and uncontrolled rents, even when adjusted for quality difference, relates to the point made at the beginning of this section concerning perceptions regarding the amount by which landlords can increase rents. If the rents for all units were deregulated vacancy rates would rise in response to the increasing rent level. The rents that landlords can charge for uncontrolled units would decline since their tenants would have more alternatives available to them.

8. In their 1985b study, Fallis and Smith estimated that uncontrolled rents were 9.2 per cent higher than equilibrium rents. Controlled rents were, again, 11 per cent lower than market clearing rents.

estimating the short-run gap. It involves explicit consideration of how market conditions have been altered by rent regulation, rather than accepting current market conditions as they are. Arnott (1981) estimated long-run rent levels by forecasting rents in the absence of regulation as a function of lagged vacancy rates, market conditions and operating cost increases.[9] Given a vacancy rate of 0.5 per cent in Toronto in 1981 and a 12.0 per cent rate of inflation, he estimated that the long-run unregulated rent level was above the actual rent level by between six and 15 per cent.

Using similar methodology, Smith and Tomlinson estimated, assuming a 5.0 per cent equilibrium vacancy rate in Ontario in 1980 and given the 1980 vacancy rate of 1.5 per cent, that equilibrium rent levels would have been 7 to 8.75 per cent higher in the absence of regulation. However, Fallis and Smith (1984) say this type of model is inappropriate for a number of reasons.[10] As an alternative they used an adjusted real rent approach. The adjusted real rent approach assumed:[11]

> . . . essentially that in the absence of rent controls the rate of increase in the real rent for a given quality of housing services would have been the same as in the recent pre-control period, and thus that the rate of increase in nominal rent would have borne the same relationship to the rate of inflation as in the recent pre-control period. (p. 44)

They estimated that equilibrium rents in the absence of regulation would be 90.6 per cent higher in 1982 than they were in 1975. Comparing calculations of actual increases in regulated rents (69.6 per cent) and uncontrolled rents (110.3 per cent), the authors concluded that controlled rents were 11 per cent lower and uncontrolled rents 10.3 per cent higher than in the absence of regulation.

Stanbury and Vertinsky (1986) argue that the uncontrolled rent level as measured by Fallis and Smith "overstates the average rent received by the landlord for his building as a whole because of the higher vacancy rate in the uncontrolled sector than in the controlled sector." (p. 6-27) According to Stanbury and Vertinsky, their (Fallis and Smith) survey in November, 1982, went only to units which were occupied. Stanbury and Vertinsky (1986) suggest:

9. Similar models are discussed in Fallis and Smith (1984), Rosen and Smith (1983), Smith (1974). Stanbury and Vertinksy (1986) briefly review the model. Walker (1977) uses this model to estimate decontrolled rent levels in British Columbia.

10. See Stanbury and Vertinsky (1986, pp. 6-22 to 6-23) for a review of this model and the reasons why it was not used.

11. This approach is also discussed in Stanbury and Vertinsky (1986). See pages 6-23 to 6-27.

> Given the less than 1% vacancy rate in the controlled sector versus almost 6.3% vacancy rate in the uncontrolled sector, the degree of overstatement of R_u [uncontrolled rent] from the landlord's point of view (rather than the tenant) is substantial. (p. 6-27)

They continue:

> It seems to us that what is important is the factor which is driving rent changes for marginal units — presumably marginal units are new units. In a two market system where uncontrolled units are new units it may be reasonable to argue that both supply and price changes at the margin are driven by vacancy rates in the uncontrolled sector only. (Ibid.)

They conclude:

> Using vacancy rates for the market as a whole may be misleading. From this approach the rental market may be in equilibrium since the relevant vacancy rate is close to the natural vacancy rate. (Ibid.)

Muller (1986, pp. 143-153 and 193-197) discusses some of the difficulties associated with estimates of economic rent levels.[12] From an analysis of data presented before the Inquiry and evidence concerning average rents in the Toronto suburbs, Muller notes as of October, 1985, that ''evidence clearly shows that average rents on controlled buildings fall far short of the economic rent on comparable new units.'' (p. 153) He comments further:

> It should be stressed that uncontrolled rents appear to be well within the range of economic rents for new construction, assuming a credible guarantee of no future rent control. (p. 153)

In the long run when rents would gradually reach their equilibrium levels, according to Muller (1986) ''the final increase in real rents would be less than 25% and would probably be of the order of 10%'' as rising real rents reduce demand and increase vacancy rates. (p. 194) A 15 per cent increase in real rents over a seven to eight year transition period ''would almost certainly restore normal vacancy rates in the rental market.''[13] (p. 195) He concludes:

12. He reviews evidence presented before the Inquiry by J. Bassel and P. Goring in Transcripts 97-2, 125-2 and 127-2.

13. Muller's estimates take into consideration the responsiveness of both demand and supply to rent increases.

> Since the calculation reported in Chapter IV suggest that some new rental supply would be economic at rents about 15% greater than current levels, this appears to be a reasonable maximum increase in real rents. (p. 195)

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Appendix C

The Magnitude of the Affordability Problem in Ontario

Introduction

This Appendix provides estimates of the magnitude of the affordability problem of renter households in Ontario and a review of the methodologies used.

Estimates have been derived[1] using several different methods and data sources. The differences in the results reflect both technical methodological differences and different assumptions (social values) about the maximum rent households should be required to pay in various circumstances.

The first section presents an important conceptual consideration related to determining the severity of an affordability problem for a single household or for all renter households. The various approaches are reviewed in the second section.

1. Conceptual Considerations

The severity of the affordability problem is indicated by the affordability gap. This also has been measured in several ways. The affordability gap is generally seen to be the difference between the actual rent paid for a unit and the socially fair rent limit[2] for the household occupying that unit. As noted in Chapter 5

1. For example, see CMHC (1983), Pringle (1986), Miron and Cullingworth (1983) and Steele and Miron (1984). Miron (1984) provides estimates for Canada only.
   Table 2, at the end of this Appendix summarizes the results of various estimates.

2. Socially fair rent limit is defined in Chapter 2 of the Report. It is a generic term which relates to any definition of the amount that it is reasonable to expect a household to pay for a unit out of its own resources. A particular definition may relate the socially fair rent to any actual rent, the household's income, composition and ages of the household and the resources available to subsidize rents. Clearly, measurements of the gap are sensitive to the way in which socially fair rent is defined in practice.

of the Report, when defined that way the affordability gap faced by a particular household may be the consequence not only of low income but also of an excessive rent charge by its landlord, excess profits in the industry and the short-term fluctuations in the market. To the household, the source of the gap between the actual and socially fair rents does not matter. From the policy perspective, however, the source will determine the appropriate response. The discussion of the affordability gap in the Report treats it as being the result of low-income problems exclusively. That is, it is considered to be the gap between the fair market rent for a unit and the socially fair rent limit of the household occupying the unit, where the socially fair rent limit is below the fair market rent. It should be noted that the definitions of the affordability problem used by the studies reviewed in this Appendix do not coincide exactly with the definition used in the Report since actual market rents may differ from fair market rents. Nevertheless, the differences are small enough that the estimates are relevant indicators of the magnitude of the affordability problem as it is defined in the Report.

The affordability gap may be measured for an individual household or for all renters. In the latter case the total gap is the sum of the affordability gaps of all households with socially fair rent limits below the rents of the units they occupy. Clearly, the affordability gap depends on the definition of socially fair rent.

2. Methodologies and Estimates

After reviewing much of the work on affordability, Marks (1984) concludes:

> Given the shortcomings of existing methods of measuring the affordability problems, one can venture an estimate that perhaps fifteen to thirty per cent of Ontario households have a housing affordability problem. Not surprisingly this figure is roughly equivalent to the present level of poverty in the province since low income usually results in problems of affordability in both housing and other markets. (p. 102)

The following three sections discuss the three most widely accepted approaches to determining the number of households with an affordability problem and the magnitude of the affordability gap: rent-to-income ratio, core need and household budget.

2.1 Rent-to-Income Ratio

A household which spends more than a specified percentage of its gross income on rent may be considered to have an affordability problem. Traditionally, a 25 per cent rent-to-income threshold has been used to indicate housing need.[3] CMHC uses a 30 per cent ratio.

Criticism of the rent-to-income ratio as an indicator of what a household can afford to pay is extensive.[4] Muller (1986) summarizes the main problems as follows:

> i) rents may be excessively high because households are voluntarily consuming higher qualities or quantities of housing than the minimum considered ''adequate'',
>
> ii) the rent actually paid may be lower than that necessary to purchase ''adequate'' housing if the household is economizing on housing expenditures in order to purchase other necessities,
>
> iii) the income used as the denominator of the rent-to-income measure may not properly measure the household's ability to afford housing,[5]

3. The problem with that test is that there are many kinds of households, young and old, single or married, with or without dependents, etc. The socially fair, or affordable, rent for a household is the amount it can spend on rent while meeting other costs in keeping with its obligations and standard of living. Since those other costs vary with the number of people in the household, its location and other factors, the affordable rent cannot be determined from income alone. For example, in a brochure published in May 1985 the Social Planning Council of Metropolitan Toronto said ''while a 30 per cent of gross income criterion may be acceptable for one-person households as an affordability benchmark; our own research indicates that 20 or 25 per cent represents a more reasonable affordability criteria for most families.'' (p. 14) Others who discuss the bases for determining affordable rent include Miron and Cullingworth (1983, pp. 93-94), Marks (1984, pp. 10-15), Steele and Miron (1984, pp. 7-10), and Stanbury (1985, pp. 2-31 to 2-36). According to Lane (1977), as cited in Marks (1984, p. 9), the 25 per cent ratio originated with the practice whereby workers were charged one week's pay for one month of company-supplied housing.

4. Marks (1984), Miron and Cullingworth (1983), Miron (1984), Steele and Miron (1984). See Adams, Ing and Pringle (1986, Section III) for a review of the relevant literature.

5. Current income is usually used in rent-to-income ratio calculations. In Miron (1984), current income is defined to include i) wages and salaries, ii) military pay and allowances, iii) net income from self employment, iv) gross income from roomers and boarders, v) interest dividends, and other investment income, vi) income from government sources including family allowances, old age security, and CPP/QPP benefits, vii) retirement pensions, superannuation, annuitites, and viii) other money income, alimony, and income from abroad. (Miron, 1984, 3.2) While it appears to be comprehensive, this list neglects other sources of funds such as gifts and inheritances. In addition due to the methodology of data collection (e.g. by the Census)

> iv) the threshold used to define the presence of an affordability problem should vary with household size and income,
>
> v) the data used to measure rent and income may be out of phase, so that income is understated. (pp. 60-62)

To correct the latter two problems, Steele and Miron (1984) project 1981 incomes forward to coincide with 1982 rents and specify a different threshold for each household size.[6] The authors argue that for any given income, larger households must spend more on other goods and therefore have less to spend on housing. Thus, as household size increases, the affordable rent-to-income ratio falls. They examine the incidence of excessive rent-to-income ratios for low-income households and low-middle-income households but exclude households with income more than twice the poverty line.[7]

Steele and Miron (1984) state:

> Our definition limits affordability problems to households below twice the poverty line . . . about half of all low-income households have an affordability problem while the overwhelming majority of low-middle-income households do not. This is a reminder that low income is a major source of affordability problems. (p. 14)

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current income in some studies, such as Pringle (1986), is the pre-tax income of the previous year although the current rent is the monthly rental payments as of the survey date. Finally, current income may overstate or understate normal income. For example, if a household is experiencing temporary difficulties through illness or unemployment its normal income would be understated. Some households, such as students or young professionals whose current income is low relative to future income, may plan to spend more than their current income with the aid of student loans or parental support.

6. The ratios were 40, 30, 22.5 and 20 per cent for households of one, two, three, four and five or more persons respectively.

7. Low-income households were those with incomes less than the Statistics Canada Low-Income Cut-off (LIC). Low-middle-income households had incomes above the LIC but less than twice the LIC. Median income is approximately twice the low-income cut-off according to Steele and Miron (1984, p.6). Upper income households were those with incomes above twice the LIC. The low-income level of living is defined as that income level at which a certain percentage of income (58.5 per cent in 1978) is spent on ''necessities'' including food, shelter and clothing. The cut-offs vary with family size and the size of the city in which the family resides. See the discussion in Steele and Miron (1984, pp. 87-90). For 1982, the low-income cut-off (1978 revised basis) for one, two, three and four person households in urban areas with 100,000 to 499,999 population was $8,466, $11,162, $14,909, and $17,229 respectively.

Steele and Miron (1984) found that 166,800 renter households or 15.5 per cent of Ontario renter households had an affordability problem in 1982. Muller (1986) notes that their findings are significantly different from those of other studies[8] of the incidence of affordability problems. Steele and Miron also found that 60 per cent of families with incomes below the low-income cut-off were paying in excess of 25 per cent of income on rent.

Miron's (1984) results for Canada in 1978, which take into account permanent and expected incomes and sources of funds, are summarized by Muller (1986):

> . . . when all sources of funds are taken into account the incidence of affordability problems is reduced, particularly among very low-income groups. When actual income is replaced by that expected for the household's measureable characteristics, such as age and education, the incidence of affordability problems rises slightly, but falls noticeably among low-income groups. Finally, when rents are related to Miron's estimate of permanent income (which reflects the present value of expected future earnings), affordability problems rise noticeably in upper income groups but fall in lower income groups. The author notes that some of the peculiar behaviour of the rent to permanent income measure may be due to the manner in which permanent income is computed. (pp. 65-66)

Miron and Cullingworth (1983) provide estimates of the magnitude or severity of affordability problems by comparing the actual housing expenditures of households with an affordability problem to 25 per cent of their income. The difference is the "annual total gap" between housing expenditures and the affordable limit assuming the limit of affordability is 25 per cent of household income (Marks, 1984, p. 11). In Ontario in 1978 the 242,000 unsubsidized renter households (or 30 per cent of all renter households) who paid more than 25 per cent of their incomes on rent had a total gap of $275.7-million.[9] Although the number of problem households has declined from 1976, the average gap per problem household has increased from $924 in 1976 to $1,139 in 1978,

8. Miron and Cullingworth (1983) and Steele and Miron (1984) used the Household Income, Facilities and Equipment (HIFE) data base in their calculations. Miron (1984) used Family Expenditure Survey data. For 1978, Miron and Cullingworth (1983) found that 242,000 households, or about 30 per cent of Ontario renter households, spent in excess of 25 per cent of income on rent.

9. Households receiving assistance through government housing programs (and from relatives in 1978) were excluded from their analysis.

and from 15.2 per cent of household income in 1976 to 17.1 per cent of household income in 1978.[10]

Additional refinements to rent-to-income ratios have been suggested by Fallis (1984) and Marks (1984). The core need and budget approaches are methods which avoid certain of the failings of the rent-toincome ratio approach.

2.2 Core Need

The core need approach eliminates those households voluntarily over-consuming or under-consuming housing[11] in estimating the number of households with an affordability problem. Burke et al. (1981) defined a core need household as one which cannot obtain standard, physically adequate housing without spending more than 25 per cent of household income.[12] This approach uses the 25 or 30 per cent rule but acknowledges that problems may result either from having to spend too much for adequate housing or from having too little housing when a household spends a reasonable proportion of income in that way. (Marks, 1984, p. 12)

According to CMHC (1983), the core need approach has three limitations:

1. specification of a rent-to-income ratio is arbitrary;
2. variation by household size and age structure in income requirements for other essentials is not considered;
3. due to limited sample size it is not possible to fully account for intra-regional variations in rental housing costs.

Additionally, Marks (1984) and Miron (1984) suggest the standards of adequacy are somewhat arbitrary and may tend to overstate the estimates of problem households. Notwithstanding these limitations, CMHC (1983) believes that the core need concept is an improvement on traditional measures of housing problems (p. 39).

10. A summary table (Table 2) at the end of section 3 contains estimates of the affordability problem in Ontario discussed in this and subsequent sections.

11. These aspects are the first two problems related to rent-to-income ratios referred to in Muller's list of problems quoted above.

12. Two traditional indicators of housing problems — physical inadequacy (as measured by structural condition or by the condition of certain basic features such as plumbing and heating) and crowding (as measured by the number of rooms per person) are no longer commonly utilized. Measures of physical inadequacy are no longer considered to be 'sensitive' (Cullingworth, 1980), and crowding is not very extensive (1.9 per cent in 1980 according to CMHC (1983)). These measures do not distinguish between those who voluntarily choose to live in physically inadequate or crowded conditions and those who do so for economic reasons. See Burke et al. (1981), Cullingworth (1980) and Adams et al. (1986, Section III) for a review of estimates using these indicators.

For Ontario, CMHC (1983) estimated there were 179,688 renter households (17.8 per cent) in core need in 1980. This contrasts with the estimated 225,101 renter households (22.2 per cent) having an affordability problem as measured by the 30 per cent rent-to-income ratio. According to Muller (1986) the CMHC study shows that on a Canada-wide level:

> Core housing needs are very significantly associated with poverty. Roughly 60% of all renter households in the lowest income quintile are in core housing need, and 93% of the rental households in core housing need fall into the lowest quintile of the income distribution. (p. 66)

Table 1 reproduces a table from CMHC (1983) which identifies senior citizens, individual female households, single parent households and households in the lowest quintile as the groups whose affordability problems are most severe.[13] Groups with the most severe affordability problems are those with a high ratio of incidence of need to proportion of rental population. A ratio above 1.0 indicates that the proportion of households in need is above the average for the population as a whole.

Muller (1986) argues that the high incidence of affordability problems in these groups may be misleading for two reasons. A group with a low incidence of affordability problems may contain a large portion of all problem households because the group itself is large. Secondly, the rent-to-income ratio specification is not varied for household size; this may overstate the number of single person households in need and understate the number of families with children in core need (pp. 70-71).

Based on those studies, Muller (1986) asserts that while rent-to-income ratios suggest serious affordability problems, corrections for deficiencies culminating in the core need approach lead to reduced "estimates of the incidence of affordability and a better ability to pinpoint groups especially in need." (p. 74) He concludes:

> Between 150,000 and 200,000 Ontario renter households are estimated to be in core need. Core housing needs are overwhelmingly concentrated in the lowest quintile of the income distribution. Within that income group, families with children (with one or both parents present) and elderly households have the highest incidence of need.

13. Similarly, Miron and Cullingworth (1983) identify elderly households, lone parent households, households without income earners and persons living alone as those groups having the greatest incidence of affordability problems. See Adams et al. (1986, Section III) for a review of studies focusing on these groups.

TABLE 1: Core Housing Need[1] for Renter Households[2] Canada, 1980.

Household Characteristics	Households in Core Need		Distribution of Rental Population (%)	Incidence of Need (%)	Ratio Incidence/ Distribution
	Number	%			
Age of Household Head					
24 and under	101,000	20.8	18.2	20.9	1.15
25-34	99,000	20.5	30.7	12.2	0.40
35-44	50,000	10.2	13.8	13.6	0.99
45-54	50,000	10.3	11.1	16.9	1.52
55-64	52,000	10.8	10.2	19.5	1.91
64-69	40,000	8.3	5.3	38.8	7.32
70 and over	92,000	19.0	10.6	32.9	3.10
Family Type[3]					
Individual(s) — male head	91,000	18.7	17.4	19.7	1.13
Individual(s) — female head	191,000	39.4	23.6	30.6	1.30
Family, no children	47,000	9.7	20.3	8.8	0.43
Family, with children	56,000	11.6	24.8	8.5	0.34
Single-parent — male	5,000	1.1	1.1	17.7	16.09
Single-parent — female	84,000	17.4	9.0	35.2	3.91
Other	10,000	2.1	3.7	10.3	2.78
Income Quintile					
First Quintile	452,000	93.4	28.7	59.7	2.08
Second Quintile	32,000	6.6	27.3	4.4	0.16
Third Quintile	*	0	20.6	0	—
Fourth Quintile	0	0	14.1	0	—
Fifth Quintile	0	0	9.3	0	—

Notes: 1. Households unable to afford adequate, uncrowded housng without paying more than 30 of gross income.

2. Data adjusted for excluded households. When adjusted for excluded households, the total number of renter households experiencing core housing need is estimated to be 521,643.

3. Family type is determined by the characteristics of the primary economic family in the household.

* The sample size is considered to be too small to provide a reliable estimate.

SOURCE: HIFE 1980 Micro Data File and Projections by CMHC. CMHC (1983) Table 3.4 as cited in Muller (1985); the ratio column has been added by the Inquiry staff.

> Additional affordability problems arise among low-income single people who, as boarders, lodgers, or hostel residents, are not counted as rental households. Affordability problems are not concentrated in the largest CMA's and affordability problems appear to have declined substantially since 1974, but may have begun to rise recently. (p. 74)

Based on the assumption that the incidence of core need by family type and age class remains constant, the number of households in core housing need is expected to grow by about 20,000 each five-year census period to 1991. This represents a growth rate of about 10 per cent per census period (Muller, 1986, p. 167).

An affordability gap related to core need would measure the difference between what a household spends on standard, physically adequate housing and 25 or 30 per cent of household income after adjusting for over-consumption or under-consumption. The 25 or 30 per cent rule is assumed to be a proxy for the socially fair rent. No estimates of a core need affordability gap have been made.

Socially assisted housing units have accommodated many renter households in core need. In 1981, there were roughly 147,000 socially assisted housing units of which 116,000 were geared-to-income housing units.[14] Waiting lists for geared-to-income housing provide a crude indication of the extent of need. In 1982, the length of waiting lists increased by 33 per cent to 17,974 for families and 6,947 for senior citizens.[15] Additional affordability problems exist among low-income single people who, as boarders, lodgers or hostel residents, are not included as rental households. Jaffary (1984) estimates that there are 80,000 boarders and lodgers in Ontario.

2.3 Household Budget

A household has an affordability problem by the household budget approach if the income remaining after allowing for non-housing needs[16] is significantly

14. MMAH (1983) p. 60.

15. MMAH (1983) p. 67. As of June, 1985 there were 16,411 families and 5,397 senior citizens on OHC waiting lists. There were 5,776 households on Toronto's Cityhome waiting lists at the end of 1984.

16. The budget approach is discussed in Marks (1984, p. 10-11) under the heading "The Affordability Gap." In this Appendix the affordability gap measures the severity of affordability problems experienced by the problem households as discussed in section 1. The latter may be estimated using the techniques discussed in section 2. The budget approach compares a household's income to its non-housing needs according to some widely accepted standard. See, for

below the household's actual expenditure on housing or the estimated cost of suitable housing (for example, by more than $100 a year). According to Marks (1984):

> Generally, there is an attempt to control for "over-consumption" of housing by imposing some upper limit on household income. One advantage of this approach is that, by using budgets that are usually location-specific, it examines affordability in the context of the local cost of living rather than embracing the 25 per cent rule. (p. 10)

Marks notes, however, that the increase in accuracy requires considerable expense for detailed data, or analyses are limited to places where sufficiently detailed data are available.

The Metropolitan Toronto Planning Department (1980) uses the residual income approach in estimating the incidence of affordability problems in the Toronto area.[17] They estimated for 1979 that about 90,000 renter households (12 per cent) in Metropolitan Toronto had an affordability problem and were not served by existing housing programs. In 1982 they estimated that about 75,800 renter households (about 20 per cent of Metro Toronto renter households) had an affordability problem and were not served by existing assisted housing.[18] The severity of affordability problems as derived from data in that study suggest a total annual gap of about $298.2-million with an average annual gap per problem household of $3,933.[19]

One income-based approach would be to utilize estimates of the costs of all living expenses including rent, to determine the minimum income a household requires. For example, the Social Planning Council of Metropolitan Toronto has calculated minimum household budgets for various types of households. According to their figures for 1984, a family of four would require an annual gross income of $24,570.[20] If the income of a household of that type was $1,000 less than the budgeted minimum, they would have an affordability gap of $1,000. To label that the housing affordability gap is to attribute the

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example, the Social Planning Council of Metropolitan Toronto's *Guides for Family Budgeting, 1983*. The income remaining after allowing for non-housing needs is what the household can afford to spend on housing.

17. This study is reviewed in Marks (1984), pp. 20-21.

18. Metropolitan Toronto Planning Department (1983).

19. As derived from Tables 25 and 26 in the 1983 study. That study provided "depth of need" data on a monthly basis for various household types within non-senior tenant, senior tenant and senior owner survey groups. The Inquiry's research staff has calculated a weighted aggregate annual value. The affordability gap in a budget context is discussed below.

20. Social Planning Council of Metroplitan Toronto, *Guides for Family Budgeting, 1984*.

entire income shortfall to housing costs. What is actually being measured is the overall income gap — that is, the subsidy which would be required to raise the household's income to the low-income cut-off, or some other measure of minimum adequate income.

In this vein, MMAH (1982) says:

> . . . the budgeting method measures more than the housing affordability gap — it measures the total shortfall of income required for all purposes. It would, therefore, seem to be an overstatement of the degree to which housing costs produce financial difficulty. Indeed, if the expenditure for other goods and services equalled the households' income, this measure would indicate that the housing affordability gap would be equal to the entire amount of housing expenditure — or alternatively viewed, that the housing affordability gap could only be eliminated if the household were to receive its housing at zero cost. (p. 108)

Table 2 summarizes estimates of the magnitude of affordability problems in Ontario. Only the Miron and Cullingworth (1983) study of 1978 figures attempts to measure the severity of the problem province-wide.

3. The Affordability Problem: Concluding Comments

Of the three approaches to determining whether a household has an affordability problem, the rent-to income ratio approach is the most commonly used, because it is the simplest, but it is the least informative. It may be misleading to say that two households which are identical in make-up both have a housing affordability problem simply because they both pay in excess of 25 per cent of their incomes in rent. If one household has an income of $12,000 per year and pays $300 in rent ($3600 annually, or 30 per cent of its income) and the other has an income of $36,000 per year and pays $900 in rent ($10,800 annually, or 30 per cent of its income), it would be hard to justify giving the former household $50 per month and the latter $150 per month in assistance to reduce the net rent payments of both households to 25 per cent of income. The core need approach is a vast improvement since it compares what a household can afford on rent, using the 25 per cent test, to the market cost of adequate housing. Hence, in the preceding example, the core need approach might indicate that adequate housing for each household would cost $500 per month; hence, the first would require assistance of $250 per month and the other would require no assistance. That is a far better reflection of affordability problems, as that problem is defined in the Report.

TABLE 2: Estimates of the Incidence and Severity of Affordability Problems in Ontario

			Incidence		Severity Average Affordability Gap[a]		
Source	Approach	Year	Number of Households (000's)	Portion of Renter Households (%)	Total Annual Gap ($ millions)	Annual Gap Per Problem Household ($)	Gap to Income Per Problem Household (%)
Steele and Miron (1984)	25% rent to income ratio	1976	225.2	25.0[b]	—	—	—
	adjusted for family size,	1980	200.7	20.1[b]	—	—	—
	income level cutoff	1982	166.8	15.5[bc]	—	—	—
Miron and Cullingworth (1983)[d]	25% rent to income ratio	1972	238.0	31.3	147.4	619	15.2
		1974	273.0	33.2	206.2	754	17.4
		1976	297.0	32.8	274.2	924	16.9
		1978	242.0	30.2	275.7	1,139	17.1
Pringle (1986)[e]	25% rent to income ratio	1981	421.1	38.6	—	—	—
	30% rent to income ratio	1981	314.1	28.8	—	—	—
CMHC (1983)	30% rent to income ratio	1976	209.0	22.4	—	—	—
	Same	1980	225.1	22.2	—	—	—
	Core need	1980	179.7	17.8	—	—	—
CMHC (1984)	Core need	1982	162.0	16.0	—	—	—
Metroplitan Toronto[f] (1980)	Household Budget	1979	90.8	24.4	—	—	—
(1983)[f]	Household Budget	1982	75.8	19.9	298.2[g]	3,938	—

NOTES: Estimates are province-wide except for the two Metropolitan Toronto studies.

a In Miron and Cullingworth gap refers to the difference between 25 per cent of income and what is being paid for rent; in Metro Toronto (1983) it refers to the budgeting gap between household income and required expenses.

b As reported by Muller (1986).

c Stanbury and Vertinsky (1985) suggest 12-16 per cent of renter households paid more than 25 per cent of income on rent.

d Unsubsidized renter households.

e Gross rent including utilities is used as the measure of rent in this study. In the other studies utilities are not included. This results in higher shelter cost estimates and, consequently, higher affordability estimates. The Metro Toronto studies (1980, 1983) include utilities and parking charges.

f Excludes households already served by existing assisted housing and senior owner households with affordability problems.

g As derived by Inquiry research staff from Tables 22A, 25 and 26 in the 1983 study. Census household type weightings were applied to the survey household type data. These are based on weighted median rather than average values which were not published.

The core need approach is inadequate in that it separates the housing affordability problem from the total affordability problem of households in an arbitrary manner. As is argued in section 4.1 of the Report, it is artifical to separate a household's housing affordability problem from its overall income problem. The budget approach[21] addresses the broader question of the gap between a household's actual income and the income it requires, given socially defined standards of adequate consumption of all goods and services. If policies are to be implemented which are designed to relieve the affordability problem of low income households, the budget approach would be the more relevant method. That, of course, would amount to implementing a general incomes policy.

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21. The fair market rent for a household may range in price significantly. Units may not be available at all times in all price ranges. As a consequence, the budget figure for a households rent should not be the lowest rents for adequate housing which can be found in the market, but rather the rent level that can reasonably be expected to be available to the household given overall market conditions. Alternatively, budget figures for a household could reflect its actual rent with a cap which relects what is available in the market.

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Appendix D

The Competitiveness of Ontario's Rental Housing Market Industry

Introduction

In this Appendix, the competitive model of the housing market is used to explain the workings of, and to draw conclusions about, the rental housing market. The limitations of the competitive model also are addressed. In particular, some housing analysts contend that suppliers of rental housing can, through their actions, influence the level of rents. Such market power may have both distributional and efficiency implications for the rental housing industry. In focussing on the supply side of the market, the Appendix examines the competitiveness of Ontario's rental housing industry.

1. Features Of Rental Housing Markets

The first section provides a brief review of features and characteristics of the rental housing market. These have been discussed extensively in the literature and in studies completed for this Inquiry. The review serves as a background and leads to the examination of the extent of landlord market power in Ontario which is discussed in section two.

That the rental housing market is perfectly competitive has been an explicit assumption in analyses by Albon (1978), Frankena (1975), Moorhouse (1972) and Olsen (1972) and implicit in many others. Rents in the absence of regulation are assumed to be at long run competitive levels. The textbook analyses of perfect competition assume that products are uniform (homogeneous), that resources, firms and consumers can move freely and easily into and out of the market, that all participants are equally well informed, that transaction costs

are insignificant, and that neither buyers nor sellers can directly influence price.[1] Muller (1986, p. 123) comments:

> Merely to recite these conditions is to invite incredulity. Virtually no market in the world conforms completely to all of these conditions.

According to Rothenberg (1977):[2]

> Urban housing markets are not a good representative of the abstract general market of conventional economic theory. They possess a number of distinctive features that are at one and the same time, integral to urban housing and difficult to integrate within conventional market theory. (p. 63)

The principal features associated with housing markets include: housing unit heterogeneity, information and transactions (moving and search) costs, durability and fixed location of the housing stock, high supply cost relative to other commodities and long lead times for new construction. On the demand side, housing consumption is characterized as being relatively immobile and inflexible — there is little opportunity for substitution. As well, external factors such as taxation policy, building and zoning regulations, interest rates and availability of financial capital influence the market. The interaction of many of these factors is said to contribute to market imperfections which prevent the market from operating in a competitive, efficient manner.[3]

For example, among housing units there are considerable variations in structure, size, number of rooms, architecture, condition and other physical attributes. In addition there are locational and neighbourhood characteristics. The considerable multi-dimensional heterogeneity of housing units implies that they are not all perfect or even near-perfect substitutes for each other. A housing market is, in effect, a set of submarkets segmented by quality, location, size, structure and service characteristics. The variation in characteristics may enable landlords to demonstrate the uniqueness of their 'brand' of units. Product differentiation in this manner may enable price discrimination wherein different rents are charged for basically identical units. Accordingly, information plays

1. For a discussion of the assumptions about the competitive model see Muller (1986), Slack and Amborski (1984) and Stanbury (1985a,b).

2. As cited in Adams, Ing and Pringle (1986).

3. These characteristics or features and market imperfections are discussed extensively in a number of studies completed for this Inquiry. Specifically see Clayton (1984), Hulchanski (1984), Muller (1986), Slack and Amborski (1984), Stanbury (1985a), Steele and Miron (1984) and Adams, Ing, and Pringle (1986). The latter study provides an extensive review of the literature in these areas (see section 1).

an important role in the housing market. Tenants must be adequately informed about the characteristics and availability of alternative accommodation in order to determine how much they are willing to pay for a unit and to avoid paying a rent that is excessive compared to other similar units.[4]

The influence of various government zoning and land use controls, housing codes and building density restrictions can be significant. Zoning and land use controls may tend to restrain supply and increase the price of housing services, may induce builders to concentrate on the upper price levels of the housing market and may create barriers to entry particularly in local markets, and building code administration and the zoning approval process may result in extended and costly construction delays.[5] One consequence of these effects on new supply is a spillover effect on the price of existing units. This results in a redistribution of resources to owners of the pre-existing stock (Slack and Amborski, 1984).

As a final example, consider the case of moving and search costs. Unless the discounted value of the difference between current rent and that of an alternative unit is less than the moving cost (including pecuniary and non-pecuniary costs) a tenant is unlikely to move in response to an increase in rent. This may give the landlord some power to set the rent above that of a similar alternative. However, as described in Stanbury (1985a) and Steele and Miron (1984), landlords incur advertising, management, redecorating and other adjustment costs and may incur vacancy losses if a tenant moves. Steele and Miron (1984) refer to "the widely observed phenomenon . . . of rent discounts associated with length of tenure." They suggest that "on balance there is a gain from being a sitting tenant." (p. 24) They conclude:

> There is no reason in general to expect landlords to exploit sitting tenants because of the power conferred on them by the existence of moving costs, although it may happen in some instances. (p. 24)

Clayton (1984) identifies the case, however, where even in a balanced rental market some tenants have less mobility. He cites the elderly or disabled, and those with language difficulties or many children, as possibly being "vulnerable to exploitation through landlords' charging them higher-than-market rents". (p. 36)

The operational consequences of these features can influence the speed and extent of adjustments of both the demand and supply sides of the market and therefore, the level of rents. Implicitly or explicitly is the contention that

4. Information and search costs are discussed extensively in Stanbury (1985a, pp. 4-18 to 4-26) and (1985b, pp. 2-34 to 2-52).

5. See the references cited in Adams et al. (1986, p. 46).

market imperfections confer on landlords some influence over the level of rents; in particular, that landlords can maintain rents above competitive levels.

2. Market Power

In order for sellers in a market to be able to maintain prices above competitive levels for a prolonged time, two conditions are necessary. First, the market must be dominated by a small number of firms and, second, there must be significant barriers to the entry of new firms when profits are above the competitive level. According to Muller (1986):

> Without the first condition, competition among existing firms will drive prices close to competitive levels. Without the second, the entry of new firms will drive prices down should incumbent firms attempt to raise them. This process of entry will be particularly rapid if there are no significant barriers to the exit of firms when profits are low. In this case the market becomes ''contestable'' and the threat of entry alone may be sufficient to maintain prices at competitive levels. (p. 129)

2.1 Small Number of Landlords

The extent to which a small number of firms dominate the market is usually assessed in terms of concentration and measured by concentration ratios. These ratios measure the cumulative market share of a small number of the largest firms. Concentration ratios can be based on activity such as value added, employment, profits or on resources such as assets. Group sizes often used are 4, 6, 8 and 20.[6] Table 1, for example, shows four-firm concentration ratios for the 20 most concentrated manufacturing industries in Canada for 1972 by value-of-shipment (based on research of the Royal Commission on Corporate Concentration (RCCC, 1978)). Table 2 summarizes concentration levels at the four-, eight-, and 20-firm group size and trends for the nine largest manufacturing industries ranked by value added in 1972.

The RCCC notes that concentration ratios fail to reflect the regional character of certain markets, and that regionally weighted national concentration

6. Other measures of concentration include the inverse ratio which measures the number of firms needed to make up a fixed percentage of the industry's activity or resources, and the Herfindahl Index which is the sum of the squares of the market shares of each corporation. For a discussion of various measures of concentration, their advantages and disadvantages, see RCCC (1978, pp. 32-42).

Table 1: Twenty Canadian Manufacturing Industries with the Highest Four-Firm (Value-of-Shipment) Concentration Ratios, 1972

Rank 1972*	Industry	Enterprises	CR_4
1.	Cotton yarn and cloth mills	9	97.5
2.	Tobacco products manufacturing (6)	11	97.1
3.	Glass manufacturing	9	97.0
4.	Breweries (1)	7	96.5
5.	Fibre and filament yarn manufacturing	7	93.8
6.	Cane and beet sugar processing	7	93.7
7.	Aluminum rolling, casting and extruding (8)	55	89.0
8.	Wood preservation industries (7)	19	87.1
9.	Miscellaneous vehicle manufacturing (11)	35	86.6
10.	Abrasives manufacturing (15)	17	86.2
11.	Manufacturing of lubricating oil and greases (5)	14	85.9
12.	Cement manufacturing	8	83.7
13.	Office and store machinery manufacturing	30	82.7
14.	Copper and copper alloy rolling, casting and extruding	45	81.9
15.	Distilleries (12)	14	79.7
16.	Battery manufacturing (14)	16	79.3
17.	Manufacturing of electrical wire and cable	17	79.2
18.	Clock and watch manufacturing	18	79.0
19.	Smelting and refining	14	78.6
20.	Typewriter supplies manufacturing	11	78.3

NOTE: * 1965 rank in parenthesis where applicable.

SOURCE: RCCC, 1978, Table 2-8.

ratios were considerably greater than the corresponding unweighted national concentration ratios (p. 33).[7]

As noted in Muller (1986) there is little information concerning concentration in the rental housing market of Ontario cities. There are two components to supply in the rental market. Land or real estate developers are one and landlords the other. Markusen and Scheffman (1976) examined concentration in land development in the Toronto region in the early 1970's. The largest six developers held 40.1 per cent of a sample of developable lands. Muller (1986, p. 129) comments that although substantial, "this is noticeably less than the average level of concentration in Canadian manufacturing industries" (cf. Tables 1 and 2). Published data on the first group is limited in applicability to the rental housing market because land is developed for ownership and non-residential use as well as rental. Moreover the total rental housing stock is

7. The implications of this in terms of the rental housing market are discussed at the end of section 2.2 of this Appendix.

Table 2: Concentration Levels and Trends for the Nine Largest Canadian Manufacturing Industries, 1965 and 1972 (Ranked by Manufacturing Value Added in 1972)

Industry	Year	Number of Enterprises	Number of Establishments	Manufacturing Value Added		Value of Manufacturing Shipments		Total Employment		Value-of-Shipment Concentration Ratios			1965-72 Trend in Four-Firm Concentration Ratios
				$ Millions	Percentage of Total Manufacturing	$ Millions	Percentage of Total Manufacturing	Thousands	Percentage of Total Manufacturing	CR_4	CR_8	Cr_{20}	
Pulp and paper mills	1965	56	132	1,033.5	6.9	2,104.4	6.2	69.9	4.4	36.9	57.1	86.3	Decline
	1972	65	141	1,374.1	5.6	3,127.8	5.6	79.0	4.7	34.4	52.5	80.1	
Iron and steel mills	1965	32	41	646.1	4.3	1,231.8	3.6	44.3	2.8	78.8	90.3	98.6	Decline
	1972	35	48	909.4	3.7	1,900.8	3.4	49.8	3.0	77.7	90.7	98.5	
Motor vehicle	1965	20	20	631.4	4.2	2,120.3	6.2	42.4	2.7	93.3	98.2	100.0	Decline
manufacturers	1972	17	22	906.8	3.7	4,033.6	7.2	44.0	2.6	n.a.	98.1	—	
Motor vehicle parts and	1965	149	160	326.6	2.2	755.6	2.2	32.0	2.0	54.2	64.4	80.7	Decline
accessories manufacturers	1972	171	211	866.6	3.6	1,903.1	3.4	46.2	2.7	48.8	64.8	79.6	
Sawmills and planing mills	1965	2,464	2,559	384.5	2.6	896.2	2.6	50.8	3.2	16.8	26.7	36.9	Increase
	1972	1,463	1,567	864.9	3.5	1,893.6	3.4	57.1	3.4	18.2	27.7	43.0	
Miscellaneous machinery and	1965	501	528	419.7	2.0	797.1	2.3	44.0	2.8	15.0	24.3	41.5	Decline
equipment manufacturers	1972	710	759	717.1	2.9	1,454.5	2.6	53.3	3.2	12.5	21.7	36.5	
Petroleum refining	1965	12	40	244.1	1.6	1,383.6	4.1	9.0	0.6	84.4	98.1	—	Decline
	1972	14	41	431.3	1.8	2,361.7	4.2	14.4	0.9	73.7	94.6	—	
Slaughtering and meat	1965	365	399	267.3	1.8	1,438.7	4.2	30.0	1.9	48.0	67.5	77.3	Decline
processors	1972	415	468	428.6	1.7	2,551.4	4.5	31.3	1.9	53.9	62.0	72.9	
Dairy products	1965	1,165	1,421	277.4	1.8	1,061.7	3.1	33.5	2.1	25.1	34.8	48.8	Increase
	1972	498	731	392.1	1.6	1,573.7	2.8	28.9	1.7	33.0	45.8	62.2	

NOTE: n.a. = not available.

SOURCE: RCCC, 1978, Table 2.9.

much larger than the additions to it even over a period of 10 years (Muller, 1986, p. 130). However, the various options for land development are substitutable, hence data on land developers provide a suitable measure of competition.

Muller (1986) cites his own earlier study (1978). Table 3 from Muller (1978) gives some evidence concerning concentration in the development of condominium apartments in the Toronto area. Over a 30-month period from 1973 to 1975, 27 builders had individual market shares greater than one per cent of condominum registration. Muller (1986) comments:

> The largest 6 of these builders accounted for almost 24% of all condominium apartment units constructed in the region. Again, this is well below average industrial concentration ratios in Canada. (p. 130)

There are no reported estimates of concentration in the ownership of rental units by landlords in Ontario. As noted in Muller (1986, p. 130) the data reported by MMAH, 1983, provide some indication. (See Tables 4 and 5) According to Muller (1986):

> Their data indicate that in 1980, 74 of 5,778 landlords in the Toronto region were corporations with portfolios of more than 5 buildings. These 74 landlords (1.3% of the total) accounted for 20.7% [90,142 units — Table 5] of the 435,174 rental units identified. While this clearly demonstrates that a very small fraction of landlords hold a large fraction of the rental stock, it also demonstrates that the share of the largest 4 or 6 must be a relatively low percentage of the total. (p. 130)

On market power, Steele and Miron (1984) support Muller. They comment with respect to concentration:

> In fact, landlords probably have little power over the market rent of a standard dwelling unitthe median rent, for example, of a one-bedroom apartment in the central part of a city. . . . In any large city there are thousands of landlords; a few own large high rise buildings and a large number own smaller buildings,[8] including single-family homes converted into duplexes and triplexes. Thus, no individual landlord can perceptibly influence market rent. (p. 21)

8. Many small landlords live in one unit in a duplex and rent out the remaining unit. In 1974, there were 38,000 owner-occupants of a rental building (Ontario 1978). In addition, of course, there are many landlords who do not occupy their rental building. As noted in Miron and Steele, fn. 14.

TABLE 3: Concentration Measures in Building, Toronto CMA, 1973-1975

Region[1]	Total No. of Builders	All Units			Ground Units			Apartment Units		
		C_6	H	N	C_6	H	N	C_6	H	N
Toronto CMA	3,917	18.3	.0104	17 (31.5)	16.7	.0095	19 (36.1)	23.5	.0186	27 (54.9)
Durham	109	60.2	.0823	19 (92.3)	60.9	.0940	20 (92.9)	100.0	.5711	2 (100.0)
Halton	505	35.1	.0338	26 (72.4)	36.0	.0391	24 (69.4)	91.3	.1519	8 (99.5)
Metro	1,629	22.4	.0154	22 (44.4)	22.0	.0131	19 (41.3)	27.0	.0228	33 (68.5)
Peel	869	26.6	.0203	25 (59.5)	28.8	.0217	20 (53.8)	48.2	.0568	23 (96.3)
York	989	40.3	.0461	17 (61.8)	37.5	.0340	18 (59.7)	86.9	.2060	10 (99.9)

NOTES: C_6 Six Firm Concentration Ratio.

H Herfindahl Index (the sum of squares market shares).

N number of firms with market shares in excess of 1% (cummulative market share of these firms is given in parentheses).

1 Only those municipalities which were also in the 1971 CMA are included in the entire for each region.

SOURCE: Reproduced from Muller, 1978; as found in Muller, 1986, Table 3.2.

2.2 Barriers to Entry

Traditional barriers to entry, according to Muller (1986), arise from:

> Absolute cost advantages of incumbent firms over newcomers including preferred access to large sums of capital, from economies of scale which cause an efficient firm to account for a large fraction of market size, and from product differentiation which effectively restricts the size of the market available to a new entrant. (p. 132)[9]

He says there is no evidence to suggest that barriers to entry are significant because:

> Economies of scale are clearly not a problem, since landlords can easily enter the market at small scale through purchase or new construction. There is no evidence that large landlords have compelling cost advatages over small ones and product differentiation, while present, still allows tenants a great deal of substitution among landlords. (p. 132)

Miron and Steele (1984) say:

> There is free entry into the rental housing industry.[10] Established landlords have no power to stop developers from erecting new buildings, and the existence of a well-developed mortgage market means that the equity capital requirements for entry are small. (p. 21)

They comment that a landlord may have some market power with respect to his particular units for two reasons. One reason they say is because a landlord's units may have unique structural features; for example, they may be the only ones available with a fireplace, although they add "such features are relatively easy to add if there is a demand for them." (p. 21) More important, they suggest, is location:

> The units may be the only ones in a particularly desirable neighbourhood. But it is questionable whether even locational advantage confers significant monopoly power. Zoning rules or other problems may make it difficult to build new units in the desirable neighbour-

9. Another source may be government-imposed or legislated restrictions such as legal monopolies, tariffs and patent protections. See the discussion of barriers to entry in RCCC (1978, p. 72)

10. However, entry can be restricted in certain locations by zoning restrictions. The importanc of this depends on the extent to which alternative locations are close substitutes. As noted Steele and Miron (1984, fn. 15, p. 93.)

TABLE 4: Ownership Type by Number of Buildings, Ontario, 1980[1]

Ownership Type	Portfolio Size (Number of Buildings)						Total	Percent of all Buildings
	One	Two	Three	Four	Five	Six +		
Corporate[2]	1,405	240	108	51	28	74	1,906	32.99
Husband-Wife[3]	924	59	14	5	4	2	1,008	17.45
Partnership	785	57	10	4	2	8	866	14.99
In-Trust	162	20	6	3	2	2	195	3.37
Individuals	1,235	157	194	9	8	4	1,607	27.81
No. Companies[4]	141	17	4	2	1	1	166	2.87
Other	24	3	0	0	0	3	30	0.52
Total	4,676	553	336	74	45	94	5,778	100.00
Percent of all buildings	80.93	9.57	5.82	1.28	0.78	1.63	100.00	—

NOTES: 1. For buildings containing six or more units located in the municipalities of Durham, Halton, Hamilton-Wentworth, Metro Toronto, Ottawa-Carleton, Peel and York.

2. The distribution for corporate owners is treated as an estimate since some owners use more than one corporate name.

3. Since some partnerships are probably also husband and wife, these two categories are not necessarily mutually exclusive.

4. Numbered companies.

SOURCE: Teela Market Survey, 1980; as found in MMAH, 1983.

TABLE 5: Ownership Type by Number of Units Ontario, 1980[1]

Ownership Type	Portfolio Size (Number of Buildings)						Total	Percent of all Units
	One	Two	Three	Four	Five	Six +		
Corporate[2]	123,441	40,835	29,979	14,634	12,473	90,142	311,504	71.58
Husband-Wife[3]	13,485	2,055	1,098	513	366	1,246	18,763	4.31
Partnership	24,484	5,133	2,401	1,000	878	2,629	36,525	8.39
In-Trust	7,785	1,855	220	800	838	300	11,798	2.71
Individuals	20,836	4,662	2,313	1,136	1,129	1,629	31,705	7.29
No. Companies[4]	17,491	1,980	852	240	80	37	20,680	4.75
Other	1,671	2,130	0	0	0	398	4,199	0.96
Total	209,193	58,650	36,863	18,323	15,764	96,381	435,174	100.00
Percent of all Buildings	48.07	13.48	8.47	4.21	3.62	22.15	100.00	—

NOTES: 1. For buildings containing six or more units located in the municipalities of Durham, Halton, Hamilton-Wentworth, Metro Toronto, Ottawa-Carleton, Peel and York.

2. The distribution for corporate owners is treated as an estimate since some owners use more than one corporate name.

3. Since some partnerships are probably also husband and wife, these two categories are not necessarily mutually exclusive.

4. Numbered companies.

SOURCE: Teela Market Survey, 1980. As found in MMAH, 1983B.

> hood, but they will generally not prevent their construction in locations that are close substitutes. (Op. cit., p. 22)

Open competition may not exist in all of Ontario's rental markets, however. According to Clayton (1984) some small rental markets such as those in small towns:

> May face a situation in which one or two landlords control all the rental units and either they control all the available suitable land or few entrepreneurs are in the area. (p. 35)

In such a case, he observes, "there may be market failure in the form of opportunities for restriction of supply and abnormal profits." (p. 35)

The incentive to create new or additional accommodation from existing housing is considerable when rents are raised above competitive levels. Steele and Miron (1984) comment:

> Additional accommodation can also come onto the market through the conversion of single-family homes into duplexes and triplexes, a process that often involves no more than the erection of a single wall and the installation of a door, or the conversion of a basement recreation area into an apartment. Freedom of entry means that if increased demand for accommodation pushes market rent above its long-run equilibrium level — that is, above the level required to cover costs and provide a normal return — the creation of additional dwelling units through new construction or conversion will ensure that this rent cannot persist for very long. (pp. 21-22)

The foregoing would seem to suggest that with the exception of some small rental markets where there may be some market power, landlords in Ontario have little influence over rent levels. Even in the small markets, if rents were to exceed competitive levels, a strong incentive would be created to provide additional supply, particularly through conversion or the creation of rental units in ownership housing.

Muller (1986) concludes:

> There are no empirical grounds to reject the basic conclusions of the competitive model because of imperfections in rental markets. (p. 133)

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Appendix E

Rates of Return on Residential Rental Investment

Introduction

This Appendix provides a review of information concerning rates of return on residential rental investments. The review pertains to the question of whether or not excess profits are the norm in the absence of rent regulation. A factual determination of whether excess profits are earned by the rental housing industry calls for both the required and the actual return on investment to be estimated. If the actual return exceeds the required return in the long-run, then it can be concluded that excess profits have been earned.

Ontario's rent regulation system, enacted in 1975, holds rents down and therefore appears to be based on the assumption that the level of profits in the industry is too high. In turn, that assumption is based primarily on perceptions of market conditions and industry structure since specific data on actual earned rates of return is limited.

A number of factors have a bearing on the availability and quality of information on profits and comparisons of returns among investors: notably, the diversity of investors and investor portfolios; non-uniformity of measuring or reporting profits; and financial disclosure practices. Accordingly, caution should be exercised in interpretation or use of the material presented in this Appendix.

An initial step, then, in examining the adequacy of profits earned in any industry is the determination of the required rate of return. For residential rental investment that rate of return is the minimum return on investment sufficient to attract private investment into the rental housing market. Hence the first part of this paper looks at estimates of the required rate of return on residential rental investments. It provides a benchmark against which to assess actual earned rates of return. Actual earned rates of return are reviewed in the second

section. The third section integrates and assesses the results of the first two sections.

1. Required Rate of Return

There are a number of indirect techniques for determining the required rate of return since it cannot be measured directly.[1] Each has advantages and disadvantages although, in theory, all should lead to the same result. Quirin (1986) uses a methodology which involves three steps:[2]

> (1) Estimation of the rate of return required by investors to invest in a portfolio of low risk, stable corporations. The estimates are based on the "discounted cash flow model" of share price determination.
>
> (2) Estimation of the risks borne by investors in low risk, stable corporations and in publicly traded Canadian property management and property development companies. These estimates are based primarily upon the "capital asset pricing model" of asset price determination.
>
> (3) Utilizing the relative risk values of the stable, low risk companies and of the property management and development companies in conjunction with the required rate of return estimates of the low risk group to establish the implied rate of return requirements for the real estate group. (pp. 162-163).

1.1 Required Rate of Return for Low Risk Group

Quirin used data produced by the Financial Post Corporation Service Computer Data Base which ranked non-financial companies according to a composite measure of relative values on five attributes of each corporation's shares to determine their relative risk level. Three of the attributes involve measures of share price instability; the others involve measures of per share earning instability.[3] Quirin (1986) suggests:

1. See Quirin (1986, Ch. 2) particularly pages 93-114 for a review. For a review of returns in financial markets see Appendix 3-A in Quirin (1986).
2. Much of the discussion in this section is drawn from chapter 3, Appendix 3-B and somewhat from chapter 2 of Quirin (1986).
3. The risk measures are described in Schedule 3-B1 of Appendix 3-B in Quirin (1986).

> The measures of share price instability are intended to measure directly the instability of the value of the investor's stake in the corporation and hence the instability of that portion of the investor's wealth. The two earnings per share instability measures can be viewed as indirect measures of the instability of the investor's wealth; the presumption is that changes in share prices are generated in large part by revisions of investors' expectations concerning future earnings levels. (p. 216)

The investors' required rate of return on a portfolio of stocks in low-risk companies is determined using the Discounted Cash Flow (DCF) model wherein the required rate of return is equal to the sum of the current dividend yield plus the expected rate of growth in dividends per share. The current dividend yield for the group is the average yield for the companies forming the group.[4] Current dividend yield for each company is measured by the Toronto Stock Exchange "indicated annual dividend" divided by the mean of the closing price per share for the three preceding months. The estimate for the expected rate of growth in the group's dividends is based on observed growth rates in the group's dividends over the preceding five, eight and 10 years. (p. 218)[5]

Thirty-two corporations were in the low-risk group but 12 were "heavily engaged in utility activities and are subject to formal regulation of the rates of return which can be earned on these assets." (p. 218-219) To avoid possibly introducing bias into growth rate estimates, these companies were excluded from the final sample.[6]

According to Quirin (1986):

> The combinations of historical time periods, index weighting, base years and measurement techniques provide 27 estimates of the investors' required rate of return as of early 1985 for the lowest risk group. The 27 growth rate estimates range from 9.0 to 13.4 percent. Adding

4. To be included in the risk analysis, a company's earnings per share data had to be available for 13 years and share price data for five years. A minimum level of share trading was required. Several companies were excluded due to disjointed financial histories.

5. Each company is given equal weight in the aggregation method. Quirin comments:
   > To ensure that the results are not unduly influenced by the happenstance of relative share prices in a particular year, the aggregation is undertaken four times, each using the mean of the high and low share prices for a particular year as weights. Essentially, the method replicates the situation of an investor who invested the same dollar amount in a given year in each of the sample companies. (p. 218)

6. One other company which recently ceased dividend payments was excluded.

> the indicated dividend yield of 3.2 percent to the growth rate estimates results in a range of 12.2 to 16.6 percent for the investors' required rate of return. The median value and the mean value are 14.2 percent and 14.3 percent respectively. (p. 219)

Further:

> These historical data suggest that the investors' required rate of return as of early 1985 was within a range of 14-15 percent. (p. 219)

However, additional analyses[7] of data concerning: 1. growth rates in real terms, 2. the prospective levels of corporate earnings implied by the historical growth rates and 3. the trend in historical growth rates indicate to Quirin (1986) that:

> The historical estimates for the lowest risk group overstate investors' requirements as of early 1985 by approximately one percentage point. Adjusting the historical estimates by this amount gives a range of 13-14 percent for the investor's required rate of return as of early 1985 for the lowest risk group. (pp. 221)

1.2 Estimation of Relative Risk

The second step in determining the required rate of return for rental housing investors is to determine the risk of such investment relative to investing in the low-risk group. The real estate group in Quirin's analysis was comprised of corporations listed by the Financial Post Corporation Service in the Developers and Contractors, and Property Management and Investment Companies classifications. A final group of 10 corporations was obtained.

The Capital Asset Pricing Model (CAPM) was used to determine relative risk. In this model, features of the cash flow stream of the 19 companies in the low-risk group and 10 companies in the real estate group were used to determine a risk premium for each group where the risk premium is the return required by investors over and above the return on a risk-free security.[8] Fol-

7. Quirin (1986, pp. 220-221).

8. In Quirin's words:

> The use of the CAPM rests on the supposed fact that risk can be portioned into systematic and unsystematic components as a result of which income fluctuates in a way which is, respectively, correlated with changes in business conditions generally or uncorrelated with such changes. The model assumes that unsystematic risk can be virtually eliminated by appropriate portfolio diversification, so that all that needs to be compensated is the bearing of systematic risk. (p. 106)

lowing this technique for the five-year period 1980-1984, Quirin found average systematic risk (''beta'') values for the lowest risk group and the real estate group of 1.3 and 2.3 respectively; for the Toronto Stock Exchange property development sub-index and the property manager sub-index, the values were 1.3 and 1.2 respectively.

Quirin (1986) comments:

> These values indicate that the risk exposure associated with the lowest risk, stable group of companies was approximately one-half the risk exposure associated with a broadly representative portfolio such as the Toronto Stock Exchange 300 Index. By the same token, the 1.2 to 1.3 values for the various real estate groups indicate that these securities as a group expose investors to approximately 20-30 percent more systematic (or undiversifiable) risk than the TSE 300 Index. (p. 222)

He concludes this section of his analysis:

> Based on these values, which will almost certainly vary from one time period to another, the risk premium (i.e., the return required over and above the return on a risk free security) required by investors to invest in the common shares of a real estate portfolio is approximately 2.5 times (1.25 divided by 0.5) the premium required by investors to invest in the lowest risk portfolio. (p. 222)

1.3 Required Rate of Return for Real Estate

For the last part of Quirin's analysis the yield on the three-month Government of Canada treasury bill is used as the ''risk free'' rate of return. Quirin (1986) arrives at the required rate of return for rental housing investors:

> Subtracting the risk free yield from the 13-14 percent estimate of the Investors' Required Rate of Return as of early 1985 for the lowest risk group results in a range of approximately 2.7–3.7 percent for

> the risk premium[9] of the lowest risk group. Applying the relative risk ratio of 2.5 to this value provides a risk premium for the real estate group of 6.8–9.2 percent. Adding this premium to the risk free rate of 10.3 percent results in an estimate of 17.1–19.5 percent for the Investors' Required Rate of Return as of early 1985. (p. 224)

One limitation to Quirin's analysis is that data are only available for publicly-traded real estate companies. These tend to be large landlords and have diversified portfolios with commercial, industrial and land holdings in addition to ownership and rental housing components. Since diversification tends to reduce risk,[10] the risk exposure of Quirin's sample probably underestimates the risk faced by landlords generally.[11]

At the present time, there is insufficient historical data on small landlords to compare empirically the risk of small and large landlords and ascertain whether or not the risk and required returns of small landlords exceeds that of large landlords.[12]

A further limitation is that the measurement process used is based on historical data on returns earned by various classes of investment. Those data have been significantly influenced by inflation.

> While the overall trend has been upward, substantial changes in both directions have become commonplace. This increased volatility in investors' required rates of return has necessitated a re-orientation of those regulatory processes utilizing the concept of a fair rate of

9. As Quirin states:

> . . . the risk premium is defined as the difference between the investors' required rate of return and the yield available on a 'risk free' security. The definition of a risk free asset is not clearcut; the asset qualifying for this sobriquet will vary with the investment horizon of the investor. For present purposes, the three month Government of Canada treasury bill has been used. (p. 223-224).

10. Due to capital market imperfections, few investors who purchase small rental buildings are able to diversify their investments; hence, the systematic risk may be relevant to their investment decisions.

11. For additional discussion on the representativeness of Quirin's sample and the applicability of the methodology to rental housing see Quirin (1986, pp. 106, 163-169). For a discussion on inflation and leverage see pages 170-201 of that study.

12. Several participants in the Inquiry's hearings appear to be of the view that small landlords face greater risk. For example, see the testimony of R. James, B. Kuhlmann, M. Vago, Transcript 37; M. Viinalass, A. Szekeres, B. Strong, Transcript 41; and R. Rae and J. Schwarz, Transcript 46.

> return. Annual determinations are now the norm in a number of Canadian regulatory jurisdictions. (Quirin, 1986, pp. 160-161)

Hence, Quirin's findings relate to the time at which his analysis was performed and cannot be assumed to be relevant for direct use in a rent regulation scheme in future years. Unless inflation rates and interest rates are much more stable in the future than they have been in recent years, the appropriate return to compare with the returns earned on alternative investments, taking into account differences in risk, would have to be calculated on an annual basis. Consequently, the results developed by Quirin (1986) should, as he said "simply be viewed as illustrative of the methodology presented [by him]." (p. 215) It serves as a model for determining the appropriate return on equity to allow landlords to earn in future years.

It should also be noted that Quirin's approach is conservative wherever uncertainty arises. As a consequence, it can be concluded that the required rate of return is at least the amount estimated by him for the period of time studied. A somewhat higher return may in fact be needed to make the rental housing industry competitive with other investment opportunities. Only after an effort to collect both current and historic data on a large sample of landlords, covering the spectrum from the smallest to the largest, can a more reliable estimate of the required rate of return be derived.

Quirin (1986) concludes his paper:

> As a final note of caution it is appropriate to reiterate that investors' required rates of return have been extremely volatile over the post-World War II period (as documented in Appendix 3-A). Consequently, the values presented in this Appendix should be viewed as illustrative only of the methodology described. (p. 225)

Quirin's (1986) conclusions can be extended to estimate the required return of publicly-traded real estate companies over a longer period of time. The risk associated with investment in those companies is 25 per cent greater than the TSE 300 Index;[13] hence, the risk premium should be 25 per cent greater than that earned on the TSE 300 Index. Using two Canadian studies cited by Quirin (1986) which show the average long-term returns on treasury bills and common stocks in place of the risk free rate and the TSE 300 Index, the required rate of return for investment in publicly-traded real estate companies would have

13. Quirin's (1986) risk estimate is based on 1980-1984 data. It is assumed that the systematic risk was the same for earlier periods.

averaged 9.64 per cent over the 1952 to 1978 period and 12.96 per cent over the 1950 to 1983 period.[14] It may be observed that the inflation rate averaged 4.76 per cent over the 1950 to 1983 period; hence, the required return averaged 8.2 percentage points more than the inflation rate during that period.[15] It again should be emphasized that these figures represent conservative (that is, low) estimates of the return required for investment in rental housing in general since the calculations are based only on publicly-traded real estate companies.

In an earlier study of the real estate industry, Kalymon (1978) used a methodology similar to Quirin's. He found for real estate a beta factor of 1.65 for the period 1972 to 1976 (compared to Quirin's 1.25)[16] which means that the risk for real estate was 65 per cent more than the risk on a market portfolio. The resulting risk premium was 10.35 per cent. A 7.5 per cent yield on 90-day Treasury Bills, used as the risk free rate of return, combined with the risk premium of 10.35 per cent, yielded a required rate of return of 17.85 per cent on real estate investments for the period 1973-1974.[17]

2. Actual Rates of Return

The available empirical studies on actual rates of return on residential rental investments can be divided into three groups based on their methodological approach. This offers a useful division for the purposes of structuring the second part of this review. The first section examines those studies which use a sample approach to the analysis of residential rental returns. The second

14. Quirin's (1986) chart on p. 212 shows:

	Federal Task Force on Retirement Income Issues (1952-1978)	Hatch & White (1950-1983)
Common stocks	8.63%	1.46%
Treasury bills	4.63	5.47
Difference	4.01	5.99
Difference × 1.25	5.01	7.49
Treasury bills + (Difference x 1.25)	9.64	12.96

15. Using a methodology similar to Quirin's, Kalymon (1978) estimated the required rate of return on real estate investments for the 1973-74 period to be 17.85 per cent, (a risk free rate of 7.5 per cent plus a risk premium of 10.35 per cent.) Kalymon found that the risk (beta factor) for real estate was 65 per cent (as opposed to Quirin's 25 per cent) greater than the market portfolio. This risk measure indicates that the required return would generalize to 10.6 percentage points more than the inflation rate.

16. Kalymon (1978, pp. 24-26 and 29-30).

17. In presentations before the Inquiry, several industry representatives suggested required rates of return on equity of around 12 to 13 per cent in the longer run as of the end of 1985. See the evidence of J. Bassel, A.E. Diamond and P. Goring.

examines returns on a case study basis. The final section reviews those studies which use an aggregate or industry level approach.

2.1 Sample Approach

A sample approach involves collecting relevant data from a subset of a population, in this case all private sector rental apartments in Ontario. Depending on the sample size and the extent of variation in average results, inferences may (or may not) be extended beyond the sample results to the entire population with varying degrees of confidence. In studies such as the one reviewed below (MMAH, 1982), where data is requested from landlords and their agents via a survey, the response rate also determines the extent to which sample results may be generalized to the total population.

In 1982, MMAH released *The Impact of Rent Review on Rental Housing in Ontario*. Table 1 shows various measures of profitability from that study as determined by Price Waterhouse (P-W) for a sample of apartment buildings each containing 20 or more units in Toronto and London, Ontario. Approximately 12 of the 66 properties in the final sample were from London which had a relatively high vacancy rate. The median rates of return on capital and equity before tax were 11.0 per cent and 13.9 per cent respectively. The corresponding after-tax rates of return were 6.6 per cent and 8.7 per cent. Mean values were not published.

TABLE 1: Median Values of Profitability Measures for Rental Housing, Ontario[1]

Profitability Measure	Period	Median Value (%)
Net Operating Income Rate	1980	9.3
Cash-on-Cash Yield	1980	6.9
Internal Rate of Return on Capital:	1971-80	
Before Tax		11.0
After Tax		6.6
Internal Rate of Return on Equity:	1971-80	
Before Tax		13.9
After Tax		8.7
Price Appreciation	1971-80	3.6

NOTE: 1. Sample of 66 buildings in Toronto and London.

SOURCE: Adapted from Ontario, Ministry of Municipal Affairs and Housing, 1982, *The Impact of Rent Review on Rental Housing in Ontario*, p. 94.

Using the same data, the Social Planning Council of Metropolitan Toronto (SPCMT) (1983) provides a breakdown of returns by control status (Table 2). In this case the rate of return measures are before tax. The median internal rates of return on capital and equity for controlled buildings were 11.8 per cent and 18.6 per cent respectively; for uncontrolled buildings they were 7.3 and minus 7.1 respectively. The SPCMT in their exhibit to the Inquiry said:

> The high interest rates during the last two years may have substantially altered these median rates of return over the short term. Nonetheless, for each of the five rate of return indicators cited, the buildings subject to rent review easily outperformed those which were not subject to review. (Exhibit 84, p. 11)

Their findings are consistent with the general pattern in the rental housing market that returns, measured using standard accounting data, are low in the early years of a building's life and rise over the lifetime of the building. Most uncontrolled buildings were less than six years when the study was conducted and controlled buildings were older. That factor is reflected in the Ministry's comments on uncontrolled properties:

> It should be apparent that the existence of controls has not altered the traditional pattern of negative returns to new buildings in their first few years of operation. Indeed, controls may have accentuated this problem in that new buildings have been restricted in the rents they can charge in relation to existing controlled rents. The negative

TABLE 2: Comparison of Median Values By Control Status[1]

	Median Value (%)		
Profitability Measure	Uncontrolled (1976-80)	Controlled (1971-80)	Total
Net Operating Income Rate, 1980	6.7	9.9	9.3
Cash-on-Cash Yield, 1980	−10.2	10.7	6.9
Internal Rate of Return on Capital[2]	7.3	11.8	11.0
Internal Rate of Return on Equity[2]	−7.1	18.6	13.9
Price Appreciation	1.9	4.0	3.6

NOTES: 1. There were 12 uncontrolled and 54 controlled buildings in the sample.
2. Before tax.

SOURCE: Adapted from Table 1 and from the Social Planning Council of Metropolitan Toronto, February 1983, Table 6 (Exhibit 84).

> return condition also provides a reason why it may be necessary to increase rents on such buildings in order to assure long-term viability of the investment. Any limitation placed on the ability to increase rents would create serious difficulties for the investors. (p. 93)

The SPCMT and MMAH results serve to highlight the effect of the building age sample profile on the representativeness of the sample results to the entire population of private sector residential rental properties. Two factors have a bearing on this. The first, as noted above, has to do with the view that returns on new properties are low and even negative initially but increase with time; the second with the proportional weightings of the sample by controlled and uncontrolled properties relative to the entire population. Due to the first factor, overall rates of return such as those in Table 1 likely would be lower than reported because of the newly constructed buildings (post-1975) earning largely low or negative rates of return.[18] Non-controlled privately initiated buildings formed a greater portion of the sample (18.2 per cent) than their occurrence in the complete universe (8.8 per cent).[19] The resulting disproportionate weighting would tend to reduce the combined rate of return further.

The Ministry study provides other return measures. Table 3 shows the static returns on investment of the sample properties compared to the rate of inflation. According to the Ministry "the Table shows that the buildings in our sample have done poorly relative to inflation during the past ten years." (p. 82)

Tables 4 and 5 facilitate a comparison of the sample properties' returns with those in other sectors of the economy. Table 4 shows returns on financial investments before tax. The returns on stocks were higher (15.4 per cent) than the median internal rate of return on both capital (11.0 per cent) and equity (13.9 per cent) for the sample buildings.[20] The Ministry (1982) says that the "returns on debt instruments, however, performed more poorly during the

18. Of 14 buildings in a slightly larger sample of exempt buildings built after 1976, 11 have negative cash flows in 1980 (MMAH, 1982, p. 93). The closer to the survey date the exempt buildings were built, the greater would be their likely negative impact on combined rates of return.

19. According to Pringle (1986, Figure 4.1, p. 150) privately initiated apartment construction built after 1975 was estimated at 8.8 per cent of the 1981 rental stock.

20. The annual average returns as reported in the bottom line of Table 4 are simple averages of annual percentage changes. To be accurate measures of returns over the period, these averages should be effective compound annual averages based on beginning and end of period index numbers. The T.S.E. annual average as reported in the Table does not include an allowance for dividend payments.

TABLE 3: Real Net Operating Income Rate and Cash-on-Cash Yield

Year	Buildings	Average NOI Rate[1]	Average C/C Yield[2]	Change in Consumer Price Index	Real NOI Rate	Real C/C Yield
1971	15	8.0	5.3	2.9	5.1	2.4
1972	18	7.4	5.1	4.8	2.6	0.3
1973	22	8.0	5.5	7.5	0.5	−2.4
1974	28	8.4	6.3	10.9	−2.5	−4.6
1975	36	8.3	3.1	10.8	−2.5	−7.7
1976	45	8.2	4.7	7.5	1.3	−2.8
1977	48	8.3	3.2	8.0	0.3	−4.8
1978	51	8.7	4.4	9.0	−0.3	−4.6
1979	62	9.3	5.2	9.1	0.2	−3.9
1980	62	9.5	5.6	10.1	−0.6	−4.5
Average 1971-80	—	8.4	4.8	8.1	—	—

NOTES: 1. NOI = Net Operating Income = Return to Capital (before tax).
2. C/C = Cash on Cash = Return to Equity.
3. 1971-80 Averages calculated by Inquiry staff.

SOURCE: Based on data collected by Price Waterhouse and Statistics Canada Consumer Price Index. As found in MMAH, 1982, p. 84.

TABLE 4: Returns on Financial Investments Before Tax

Year	T.S.E. 300 Composite Stock Index	Long Term Bonds	90-Day Financial Paper	5-Year Guaranteed Investment Certificates	Interest Rate Savings Deposit
1971	30.13	2.48	13.60	12.31	11.15
1972	44.48	−2.60	11.73	10.33	10.13
1973	29.81	4.10	8.48	9.27	7.87
1974	10.74	9.16	7.78	8.94	6.00
1975	11.02	23.32	9.84	10.09	8.45
1976	18.48	8.05	8.59	9.56	7.45
1977	−25.93	−4.55	10.97	9.70	6.50
1978	0.27	1.99	6.85	8.21	5.43
1979	27.38	8.09	5.09	7.62	4.00
1980	8.01	14.83	4.60	7.72	4.50
Annual Average	15.4	6.5	8.8	9.4	7.1

SOURCE: Bank of Canada Review. As found in MMAH, 1982, p. 87.

1970's due to a consistent underestimation of inflation by investors during the period.'' (p. 85) With reference to Table 5:

TABLE 5: Return on Capital After Tax in Various Industries

Industry	1980	1979	1978	1977	1976	1975	1974	1973	1972	1971	Annual Average 71-80
Industry in General	15.8	16.0	12.9	11.6	11.7	11.6	12.5	8.5	7.8	8.9	11.7
Real Estate and Construction	9.7	10.0	8.9	8.3	8.1	7.5	7.7	6.5	5.6	6.8	7.9
Primary Metals	13.4	12.9	11.3	8.1	6.2	7.8	11.3	9.0	6.8	7.7	9.5
Manufacturing	14.3	15.0	10.4	9.8	10.7	11.1	12.9	12.1	6.9	8.1	11.1
Machinery	13.3	19.5	14.3	12.0	14.9	17.3	15.4	16.3	11.9	8.1	14.3
Electrical Equipment	20.7	4.3	10.0	6.8	9.4	14.3	9.9	3.8	9.1	7.5	9.6
Sample Buildings	5.9	5.8	5.6	5.4	5.4	5.3	5.3	5.1	5.0	5.5	5.4

SOURCE: Statistics Canada 61-003 and 61-207 and data collected by Price Waterhouse. As found in MMAH, 1982 p. 86.

> It can be seen that Real Estate and Construction performed poorly in comparison to Industry in General and, in most years, in comparison to the other selected industries. (p. 85)

For example, in 1980, the return on capital for Real Estate and Construction was 9.7 per cent.[21] For Industry in General it was 15.8 per cent. The return on capital for the sample buildings was 5.9 per cent.

The Ministry concludes:

> In general, then, the buildings in our sample did not perform strongly relative to their landlord's targets, the rate of inflation, the returns in other industries or the stock market. They did, however, perform better than investors in the bond market. Even here, it may be noted, things may have changed in that current [1982] purchasers of bonds are obtaining rates of interest in the 15 per cent range. (p. 85)

In a study for this Inquiry, Campbell Sharp (1984) examined the profitability of eight rent regulated properties containing a total of 943 units in Mississauga, Oshawa, Ottawa and Toronto. Results were obtained for the period 1970 to 1983 although the number of properties was not constant through the entire period. The number of units increased from 417 in 1970 to 943 in 1975 but declined after 1980 to 894 in 1981, 741 in 1982, and finally 611 units in 1983. On the sample size the authors comment:

> Because of the small size of the test group, observations can only be drawn for the group and individual properties within it. Although the properties are located within four separately identifiable geographic regions, no conclusions can be drawn with respect to the state of the industry within each region, between or among regions, or for the province. The 943 units in the sample constitute less than 1/10 of 1% of the total number of rental units in Ontario. (p.3)

Table 6 shows a general increase in return on investment (actual earnings before debt service and depreciation expressed as a percentage of undepreciated original asset cost — row 6) from 9.0 per cent in 1970 to 11.9 per cent in 1983. When inflation is eliminated from the earnings the data show a steady decline (row 7). Also from Table 6 it can be seen that "the progression in estimated market value [row 4] has been progressively less than the estimated replacement cost [row 3]." (p. 19)

21. Problems related to this aggregate type of industry data are discussed in section 2.3.

TABLE 6: Significant Economic Indicators Per Rental Unit, Selected Years

	1970	1975	1976	1983
Inflation Index (CPI) (%)	97.2	138.5	148.9	277.5
Original Cost[1] ($)	9,634	13,223	13,240	10,948
Original Cost (Adjusted for Inflation) ($)	9,951	17,852	19,210	29,916
Estimated Market Value[2] ($)	9,578	13,078	13,811	14,422
Unrealized Capital Appreciation ($)	(56)	(145)	571	3,474
Actual Earnings as a % of Original Cost[3]	9.0	8.9	9.4	11.9
Inflation Adjusted Earnings as a % of Original Cost[3]	9.2	6.4	6.3	4.3
Actual Earnings as a % of Inflation Adjusted Original Cost	8.7	6.6	6.5	4.3

NOTES: 1. Per unit original costs fluctuate as units are added to or deleted from sample.
2. Earnings before interest, depreciation and income taxes capitalized at 9%.
3. Earnings before interest, depreciation and income taxes.

SOURCE: From Campbell Sharp, 1984, Schedule B-II, p. 28.

The authors note that landlords' profitability prior to rent control "was already in a decline on both a percentage of revenue basis and on an earnings dollar per unit basis." They suggest, however, that the "introduction of rent review legislation appears to have accelerated the decline." (p. 23) They make the following observations:[22]

> — real profitability has declined by about 1/3 since 1970; most of the decline occurred during 1974 and 1975 and the period 1976 through 1983. Inflation appears to be the cause of the profitability decline in 1974 and 1975. Thereafter, the impact of inflation and the ceilings on rent increases apparently caused the profitability decline.
>
> — conversely, the increase in actual profits was significantly below the rate of inflation both before and after the implementation of rent

22. See Campbell Sharp (1984) for full documentation of results and observations. Their calculated returns exclude consideration of any capital appreciation. Their observations individually appear to indicate reduced profitability. Taken as a whole, however, that might not be the case. These aspects are discussed in section 3.6.1 of the Inquiry's Report.

review. However, the disparity between the growth in actual profits and inflation was much greater after rent review was introduce.

— operating expenses did not abate over the period. They actually grew by an amount virtually equal to the rate of inflation.

— insofar as actual rent received grew at a substantially lower rate than the rate of inflation after 1975 (actual rent grew at a rate very close to the rate of inflation before the implementation of rent review), the benefits passed on to tenants through lower rents were paid for by the landlords in the form of a reduced return on investment (R.O.I.).

— the declining R.O.I. is reflected in the wide disparity between the estimated market value (using earnings before interest depreciation and income taxes as the measure of value) and the inflation-adjusted original cost.

— real earnings (expressed as percentage of original asset cost) since 1975 can be seen to be well below the range experienced before the first impact of inflation in 1974/1975 and rent review in 1975/76. Recent returns are well below returns that may be realized from investing in risk-free securities such as government bonds or term deposits [see Table 7]. (p. 38)

A study done for CMHC in 1970 by Woods, Gordon and Company was reported to be the only publicly available documentation of profits in rental housing as late as 1974. The study set out to examine annual after tax rates of return for investors in apartment and common stocks over the period 1960-1969 and to indicate the likely impact of proposed federal tax changes (which were implemented in 1971). The returns on apartment investments appear to be high (see Table 8). Under the existing tax system the rates of return for apartment investors were substantially higher than returns for common stock investors, particularly in some categories. After the tax changes, according to the study:

> The rates of return for some classes of apartment investors, namely closely held companies and widely held companies would remain substantially higher than returns for common stock investors if the White Paper's proposals were implemented. However, individuals investing in apartments would in the post White Paper situation have only slightly higher rates of return than if they invested in common stocks. (p.2)

TABLE 7: Comparison of Landlord Profitability to Alterntive Investment Opportunities, 1970 to 1983 (Per cent)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Government of Canada Securities Bond yield average 10 years and over	7.91	6.95	7.23	7.56	8.90	9.04	9.18	8.70	9.27	10.21	12.48	15.22	14.27	11.77
McLeod Young Weir yield averages – 10 provincials	9.04	8.03	8.13	8.36	9.91	10.17	10.11	9.53	9.88	10.74	13.01	15.95	15.40	n/a
Trust company 5-year Guaranteed Investment Certificate	8.51	7.69	7.64	8.25	9.75	9.55	10.05	8.94	9.31	10.46	12.36	15.39	14.43	10.57
Landlord Profitability (Calculation 1 and 2)[1] —actual earnings before interest and depreciation plus capital appreciation increment as a % of inflation adjusted cost	8.22	17.48	12.09	12.18	13.99	8.27	10.29	6.99	7.34	9.22	9.52	8.13	6.22	−7.03
inflation adjusted earnings before interest and depreciation plus capital appreciation increased as a % of original cost	8.74	18.38	12.68	12.34	13.78	8.06	10.02	6.81	7.15	8.95	9.21	7.73	5.93	−6.92

NOTE: 1. See Campbell Sharp, p. 31, for the individual calculations.

SOURCE: As found in Campbell Sharp, 1984, Schedule B-V.

The authors of the study provide a number of qualifications to the apparent high apartment returns:

> 1. The small sample may account for high returns enjoyed by individuals;
> 2. High leverage may account for some high returns. Offsetting this were cases where investors had no mortgages;
> 3. Assumptions had to be made about income otherwise available to investors for tax shelter calculations, and about the rate of return on reinvested profit.[23]

Another study concerns the British Columbia market in the early 1970s. In a report prepared for the B.C. Rentalsman, Cragg (1974) reports rates of return on capital as determined by landlord responses to a survey administered by Clarkson, Gordon and Company. Landlords were asked the market and replacement values of their buildings in the fall of 1974. Cragg comments on the data source:

> Needless to say, one should be very suspicious of these figures, whose exact basis is not always known. On the one hand, one might suspect that landlords would tend to over-estimate the values, partly because the Survey was conducted on behalf of the Rentalsman. However, it cannot therefore be presumed that the capital values reported are excessive. It is quite possible that many landlords based their appraisals on sales figures which are out-of-date or that they have not fully taken account of recent changes in capital costs . . . these have been very large. One might also argue that landlords have been overly pessimistic about the effects of rent control on the value of their properties. Any of these reasons would produce a downward bias. (p. 57)

Rates of return were calculated using the responses to the questionnaire. Incomes used also were based on landlord responses. Results are shown in Table 9. Rates of return on capital as measured by income/replacement value and income/market value, for weighted aggregate totals in 1973, were 4.43 and 4.91 per cent respectively. For 1974 they were 4.63 and 5.09 per cent. The

23. In a review of the Woods, Gordon study the British Columbia Interdepartmental Study Team on Housing and Rents (1975) suggests the period under study was considered to have been particularly profitable for apartment investors as another reason why reported returns may have been high. As well they indicate "the deviation in results was excessive in every category except widely held corporations where the lowest returns were recorded." (B.C. 1975, p. 16)

TABLE 8: Average Annual After Tax Rates of Return* Calculated for Investors in Apartment and Common Stocks, Pre and Post White Paper on Taxation, 1960-1969

	Closely Held Corporations		Widely Held Corporations		Individuals Direct: Death Option		Individuals Direct: Selling Option		Individuals Through Closely Held Corporations	
Type of Investment	Pre %	Post %	Pre %	Post %	Pre %	Post %	Pre %	Post %	Pre %	Post %
Apartments	50.22	22.61	19.24	10.14	44.41	25.70	57.21	8.55	30.06	7.47
Common Stocks	7.72	5.89	7.72	5.75	N.A	N.A	6.24	5.80	6.24	4.82

NOTES: *This table should only be used in conjunction with the qualifications noted in the text. N.A. Not applicable.

SOURCE: Reprinted from Woods, Gordon and Company, 1970, Table 2.

1973 rates of return were lower than for 1974. According to Cragg, this was due to two factors. First, landlords had received an increase in income net of current expenses. Second, the 1974 capital base was used to calculate both years' rates of return because data were not available on the 1973 capital base. The implication is that the true 1973 capital base was somewhat lower; hence the 1973 rate of return was under-estimated. With respect to the level of return he comments:

> The rates of return shown in [Table 9] are hardly enormous. Instead, they indicate only a modest return from rental revenue and would not support the belief that excessive rates are being earned. (p. 59)

Earlier in the report Cragg states:

> If it is true that landlords in general are reaping and can expect to reap profits in excess of those needed to induce them to provide housing, then rent control might be used to remove this excess amount safely.
>
> There can, however be little presumption that excess profits in this sense are being earned generally in rental housing. The major housing markets in British Columbia have large numbers of apartment owners and one would expect that competitive forces would normally limit rates of return to reasonable amounts. No fully detailed study of

TABLE 9: Rates of Return on Capital (Per cent)

	Aggregate Totals			
	Weighted		Unweighted	
	1973	1974	1973	1974
Income/Replacement Value	4.43	4.63	4.54	4.67
Income/Market Value	4.91	5.09	5.06	5.25
	Based on Average of Responses (Standard Deviations in Parentheses)			
	Weighted		Unweighted	
	1973	1974	1973	1974
Income/Replacement Value	4.53	4.82	4.56	4.52
	(1.83)	(1.87)	(1.75)	(1.94)
Income/Market Value	5.21	5.42	5.29	5.63
	(1.59)	(1.70)	(1.60)	(1.75)

SOURCE: Survey of landlords as found in Cragg, 1974, p. 58.

> rental housing or rates of return in it is available, but the figures discussed later in this report give no presumption that excessive returns are being obtained from rents. (pp. 6-7).

Peter Larmour in his *Preliminary Report on Rent Control* (1975) emphasizes that there is more to overall return than just return from revenue. With respect to the Cragg study he says:

> This reasonable amount is a reasonable return on the capital value of existing stock inflated by the effects of rising building costs. (p. 19)

Following a discussion of the depreciation, leverage and tax shelter factors,[24] Larmour (1985) presents hypothetical returns calculations showing the importance of these factors to return on equity. He suggests "the rational investor is apt to keep refinancing property up to its limit, particularly in a rising market, since such practices are to his advantage." (p. 28) Further:

> Now all of these investment considerations make it highly advantageous for there to be a rapid turnover of rental properties. It would be interesting to know if there is such a turnover, or to what extent these considerations are a factor in the local rental market. Relating these conclusions back to the earlier considerations on the effect of a rise in building costs on capital gains in the housing market, the real impact of the earlier findings come to be felt. For if there is a large turnover, this means that the unrealized capital gains tend to become realized capital gains; and from being in a sense hypothetical costs, the inflated value of existing stock becomes real costs. And although very large profits through the various provisions noted above continue to be made, at any given moment the real profit (cash flow measured against property value or equity) is apt to appear (and be) quite modest. (pp. 28-29)

George Gau (1983) in a study of the Vancouver real estate market looked at the returns of a sample of 211 income producing properties comprised of 140 apartment and 71 commercial buildings which sold in 1979. While the MMAH study estimated capital appreciation values, this study, because all

24. See Larmour (1975, pp. 22-28), MMAH (1982, Chapter 4) and Lorimer (1978, Chapter 3) for discussion of these factors. Muller (1978, pp. 116-117) discusses tax deferral.

sample buildings were sold, was able to measure reversion cash flows[25] and determine holding period returns including any capital gains. Seventy-eight per cent of the apartment properties contained between six and 23 units. The sample properties ranged in size from a low of four units to a high of 103 units.

The study utilized two discounted cash flow models to evaluate the properties, the internal rate of return (IRR) model and the net present value (NPV) model.[26] Based on these techniques, three after-tax rates of return on equity (RE) and three NPVs were calculated: 1) RE-I and NPV-I, with the after-tax cash flows assuming full tax-loss sheltering; 2) RE-II and NPV-II, with the after-tax cash flows under the condition of no tax-loss shelters from depreciation for the years 1972 through 1979; 3) RE-III and NPV-III, with the aftertax cash flows assuming no debt financing. For the NPV calculations, the required rate of return was 12 per cent before-tax and six per cent after-tax annually. The results are recorded in Table 10.[27]

According to Gau (1983), for the apartment properties "the mean of 24.4 percent is probably the best reflection of the average yearly rate of return earned over the investor's holding period under conditions of tax-loss sheltering." (p. 20) If the investors do not claim income tax losses from depreciation deductions, their average rate of return drops to 21.1 per cent (RE-II). Gau

TABLE 10: Return Measures — Apartment and Commercial Properties, Vancouver, 1979

	Apartment		Commercial	
Measure	Mean	Standard Deviation	Mean	Standard Deviation
RE-I	24.4%	24.5%	19.7%	33.0%
RE-II	21.1%	22.0%	19.0%	25.8%
RE-III	10.3%	7.9%	11.7%	12.8%
NPV-I	$61,893	$100,271	$84,757	$218,235
NPV-II	$58,673	$ 97,742	$80,550	$219,060
NPV-III	$50,258	$ 86,869	$74,948	$207,671

SOURCE: From Gau, 1983, Tables 7 and 8.

25. Reversion cash flow at the end of a holding period is equal to the selling price of the property minus capital gains taxes and any taxes on the recapture of depreciation or capital cost allowances, and minus any outstanding mortgage balance at the time of sale. See Gau (1983, p.31).

26. These models are described in Appendix Two to Gau's study. (pp. 30-31)

27. These results were calculated after adjustment for infinite returns and extreme values among the rates of return. The final subsamples contained 131 apartment properties and 64 commercial properties.

suggests for these investments "tax-shelter benefits are not major determinants of the equity returns." (p. 20) More important, he says:

> . . . is the impact of financial leverage. The mean value of the rates of return in the absence of debt (RE-III) is only 10.3 per cent. The large difference between RE-II and RE-III clearly demonstrates the influence that financial leverage can have on real estate returns. (p. 20)

In discussing the role of price appreciation in total return, Gau (1983) comments:

> In comparing the relative importance of operating and reversion flows, price appreciation plays a greater role in this sample in determining an investor's return than operating incomes. Partially explained by the presence of rent controls, the reversion flow in many of those apartment investments is the only positive contributor to the net present value and therefore wealth of the investor. (pp. 20-21)

The returns to investors in commercial properties were lower than investors in apartments and had greater variation as evidenced by the high standard deviation for the commercial properties.[28]

A comparison to data from the United States showed apartment returns close to those of retail investors returns but less than investor returns on office building properties.

On the level of returns, Gau summarizes:

> The high returns earned on these properties are no "free-lunch" for the equity investors, since the level of risk is also quite high. Almost 10 per cent of the investors in both types of properties suffered financial losses (negative rates of return), and about 20 per cent failed to earn a return equivalent to the interest on a government security. (pp. 2-3)

2.2 Case Study Approach

The case study approach generally takes a particular firm and, given various features related to the background — ownership, development and management practices of that company — analyzes such concerns as marketing strategies,

28. The commercial properties were comprised of retail, office, retail/office and restaurant/club categories.

expansion opportunities and profitablity. The reported results of such studies are not meant to be generalized to all firms in the industry — rather, they are meant to stand on their own and often provide insights into possible outcomes of specific strategies adopted by firms, given their respective background and management practices.

Another study which differentiated rental income but on a single firm basis, is Ira Gluskin's 1976 study of Cadillac Fairview Corporation for the Royal Commission on Corporate Concentration. Gluskin isolates rental income from the total portfolio returns and distinguishes among the residential, shopping centre and office buildings components (see Table 11). Gluskin (1976) notes:

> As a percentage of total investment in rental properties, cash flow from residential rentals was 3.9% in 1976 compared with 3.0% for office buildings, and 7.2% for shopping centres. The free and clear return from residential rentals was 10.4% as compared with 9.5% for office buildings and 13.4% for shopping centres.[29] (p. 115)

He continues:

> These statistics appear to place residential rentals midway in profitability between office buildings at the bottom and shopping centres at the top. In actual fact, as we explain below, the economics of new apartments is the worst of the three. The reason the historical returns do not demonstrate this is that the residential rental portfolio contains a higher percentage of older buildings [which have higher returns]

TABLE 11: Return on Capital for Rental Income Portfolio, Cadillac Fairview, 1976 (Percent)

	Cash Flow Return	Free and Clear return
Residential	3.9	10.4
Office Buildings	3.0	9.5
Shopping Centres	7.2	13.4

SOURCE: Dervied from Gluskin, 1976, Tables 37, 38, 52, 53, 67 and 68.

29. Free and clear return measures the cash flow return after allocation of general and adminis trative expenses but before financing. As with the Campbell Sharp analysis, these returns exclude consideration of any capital appreciation.

> than do those of the Urban Development and Shopping Centres Group. (p. 115)

The reasons why the economics of new apartments is the 'worst' are attributed to high construction and finance costs and low market rents (p. 121).

In commenting on the desirability of having new rental units built, Gluskin (1976) says:

> It will be recalled that the rate of return figures for offices did not appear very attractive and yet office buildings are still being built. The current economics of new hotel construction is even more unfavourable yet construction continues. Similarly, in our opinion, apartments will be built as soon as the potential returns are visible. (p. 121)

Cadillac-Fairview had relatively lower cash flow generated from apartment rentals because: 1. renovations and repairs were much higher; and 2. refinancings were likely occurring because of the age of the portfolio and the short-term nature of financings formerly used by Cadillac (p. 121). Gluskin (1976) notes:

> In ordinary times, the quicker turnover of leases might compensate for the negatives. In a rent controlled environment, the opportunities for such compensation are eroded sharply. (p. 121)

2.3 Industry Level Approach

An industry level aproach to an analysis of profitability makes use of available, reported information. The degree to which the results can be generalized to all firms in an industry depends on such aspects as the size of reporting firms relative to all firms, differences between publicly listed and private firms, and the comparability of data and measurements among reporting firms.[30]

Table 12, reprinted from Gluskin (1976), provides measures of profitability on rental incomes from all sources for 23 public real estate firms. For 1975, the average free and clear return as a percentage of average net properties (a measure of profitability before financing) was 11.3 per cent for these com-

30. Some problems related to published industry-wide data relevant to rental housing were mentioned in section 1 of this Appendix. Others are reviewed in this section.

TABLE 12: Comparative Income Property Returns 23 Public Companies, 1975 ($000's)

	Gross Rentals	Operaing Expenses	Free and Clear Return	Interest	Cash Flow from Income Properties*	Average Net Income Properties		
						Amount	Percentage Free and Clear Return	Percentage Cash Flow
Cadillac Fairview	122,898	54,261	68,637	34,409	34,228	572,024	12.0	6.0
Trizec	117,200	52,800	64,400	42,400	22,000	590,000	10.9	2.0
Campeau	50,537	23,120	27,417	14,000	13,417	232,705	9.6	5.8
Oxford	40,987	10,908	30,079	21,543	8,536	238,885	12.6	3.6
MEPC	22,952	8,655	14,297	8,757	5,540	143,988	9.9	3.8
Abbey Glen	22,789	11,440	11,349	10,223	1,126	142,865	7.9	0.8
Bramalea	14,479	7,200	7,279	5,845	1,434	59,000	12.3	2.4
Y & R	13,794	6,759	7,035	3,086	3,949	62,967	11.2	6.3
Orlando	11,679	1,614	10,065	5,982	4,083	76,325	13.2	5.4
Revenue	11,291	7,207	4,084	3,000	1,084	35,504	11.5	3.1
S.B. McLaughlin	10,081	3,110	6,971	5,813	1,158	51,675	13.5	2.2
Daon	10,073	4,155	5,918	5,500	418	57,375	10.3	0.7
Sifton	8,572	3,158	5,414	3,605	1,809	43,265	12.5	4.2
Block Brothers	8,496	3,134	5,362	3,000	2,362	52,234	10.3	4.5
Halifax	8,154	4,759	3,395	2,420	975	35,732	9.5	2.7
Markborough	7,741	3,333	4,408	2,376	2,032	41,398	10.7	4.9
Imperial General	5,854	1,620	4,234	2,342	1,892	40,315	10.5	4.7
Monarch	5,228	2,273	2,955	1,200	1,755	21,033	14.1	8.3
Consolidated Building	3,047	2,146	901	1,100	(199)	15,741	5.9	neg
Alliance	2,890	538	2,352	3,300	(52)	25,795	9.1	0.2
Nu-West	2,750	1,200	1,550	1,200	350	13,381	9.0	2.6
Richard Costain	2,069	1,292	777	1,082	(305)	14,101	5.5	neg
Melcor	1,986	857	1,129	836	293	9,965	11.3	2.9
Totals	505,547	215,539	290,008	182,019	107,989	2,577,133	11.3	4.2

NOTE: *Before allocation of corporate, general and administrative expenses.

SOURCE: Reprinted from Gluskin, 1976, p. 170.

panies; cash flow as a percentage of average net properties was 4.2 per cent.[31] Of the five most profitable companies, four were active in shopping centres. Of the five least profitable, two had residential apartments as the mainstay of their portfolios; three had no shopping centres at all (p. 172).

Table 13, also reprinted from Gluskin (1976), shows data aggregated over total company portfolios including land development and sales, residential sales (condominium and single family residences) in addition to the rental income portfolio. Gluskin notes:

> The total industry itself had a cash flow return on total assets of 6.4% in 1975, and 29.5% cash flow return on equity and 14.8% in terms of net profit. (p. 187)

Gluskin suggests high profits can be related to the land development end of the industry with leverage playing a determining role. He comments:

> There can be no doubt that the absolute level of profits in the development industry has inclined sharply over the past five years. The author has made this statement quite openly and disagrees with the statements of the industry spokesmen who fail to acknowledge the high profit level. It is the leverage that accounts for the high profitability.[32] (p. 157-158)

Muller (1978) examined the Toronto residential market over the period 1966 to 1975. Table 14, reproduced from the study, shows after-tax rates of return on shareholder's equity for five public real estate companies active in the Toronto market. Table 15, also from the study, shows comparative data for nine industrial divisions of the Canadian Standard Industrial Classification. Muller (1978) comments:

> The five public developers earned above average rates of return in four of the six years 1968-1973. The mean return on equity over that period was 9.6 percent for the developers and only 7.6 percent for all corporations. Since these five developers are the largest in the

31. For a discussion of methodology, explanation of terms and reasons why returns to equity were not calculated, see Gluskin (1976, p. 168-169).

32. Several studies have examined land development firms principally in the context of concentration of ownership as a potential contributor to speculation and restraints on the availability of supply of serviced land. See Dennis and Fish (1972, pp. 323-325), Markusen and Scheffman (1977) and Spurr (1974, 1976). Sections on profits in the real estate and development industry in a related study (Muller, 1978) are reviewed below.

TABLE 13: Comparative Public Real Estate Data, 1976 ($000's)

	Year End	Total Assets	Total Gross Revenues	Gross Cash Flow	Net Income	Common Shareholders' Equity	Common Equity Average for Year	Cash Flow as % of Average Common Equity	Net Income as % of Average Common Equity
Cadillac Fairview	Feb 29/76	1,045,157	200,396	40,827	16,489	135,836	126,301	32.3	13.1
Trizec	Oct 31/75	899,714	170,327	17,814	3,234	115,844	112,935	14.5	2.9
Campeau[3]	Dec 31/75	481,695	139,696	16,467	7,568	46,734	43,037	39.3	16.3
Oxford Developments	Mar 31/76	474,800	45,911	10,327	3,033	41,869	35,365	29.2	8.6
Deltan	Dec 31/75[7]	390,495	67,772	9,466	1,970	20,205	20,254	46.6	9.7
Abbey Glen	Mar 31/76	387,586	107,747	16,387	8,276	75,511	72,808	22.5	11.4
Bramalea	Jan 31/76[3]	279,143	66,339	9,812	3,540	26,193	27,089	36.2	13.1
S.B. McLaughlin	Dec 31/75	256,402	61,091	9,141	3,930	33,228	31,088	29.4	12.6
Daon Developments	Oct 31/75	209,963	102,939	12,921	6,694	19,319	16,152	80.0	41.4
Nu-West[2]	Dec 31/75	187,143	143,399	13,329	13,953	36,509	30,155	44.2	46.3
M.E.P.C.[3 1]	Sep 30/75	179,505	23,647	5,560	3,245	32,325	31,237	17.4	9.9
Cmnwlth Hol. Inns[3]	Oct 31/75	160,361	120,695	8,522	413	21,290	21,265	38.2	—
Block Brothers	Jan 31/76	146,767	41,6315	9,077	5,712	24,303	22,796	39.8	25.1
Markborough	Oct 31/75	142,104	26,516	6,793	4,283	38,424	36,283	18.7	11.8
Orlando	Dec 31/75	120,230	28,766	5,029	2,248	12,680	11,948	42.1	18.8
Revenue Properties	Dec 31/75	104,476	21,479	1,827	580	20,510	20,185	9.1	2.9
Carma	Dec 31/75	103,523	39,487	11,594	7,266	23,282	18,977	61.1	38.3
Allarco Developments	Dec 31/75	101,356	12,999[6]	4,134	3,307	17,417	15,763	26.5	21.0
Consolidated Bldg.	Feb 28/76	100,583	32,281	2,682	2,372	17,802	17,094	15.7	13.9
Y & R Properties	Dec 31/75	98,149	22,698	4,301	1,584	21,436	20,324	21.2	7.8
Alliance Bldg.	Dec 31/75	97,706	34,202	2,922	695	10,319	8,567	34.1	8.1
Sifton Props.	Dec 31/75	94,354	28,847	5,278	2,072	9,240	8,448	62.5	24.5
Richard Costain	Dec 31/75	92,618	38,337	4,931	3,192	13,143	11,815	41.7	27.0
Headway	Aug 31/75	81,889	34,654[4]	2,330	1,134	10,813	10,247	22.7	11.1
Four Seasons Hotels	Dec 31/75	67,123	31,168	3,447	1,505	15,801	15,349	20.9	8.2

TABLE 13: Comparative Public Real Estate Data, 1976 ($000's) *(Continued)*

Monarch Investments	Dec 31/75	63,923	26,964	2,747	2,812	17,025	15,725	17.5	17.9
Imperial General	Oct 31/75	62,126	6,337	2,061	758	11,240	10,861	19.0	7.0
Halifax Devel.	Dec 31/75	48,149	8,154	1,033	256	8,543	8,458	12.2	3.0
Melcor	Dec 31/75	46,931	37,313	4,450	3,494	9,990	8,249	53.4	42.4
Skyline Hotels	Dec 31/75	42,469	32,782	308	(667)	5,247	5,581	5.5	neg
Major Holdings	Dec 31/75	34,681	12,167	4,494	1,538	5,373	4,722	94.7	32.1
Corporate Properties	Dec 31/75	24,385	13,269	814	112	3,268	3,212	25.3	3.4
Sobey Leased Props.	Jan 31/76	19,406	2,089	650	305	3,171	3,037	21.4	10.0
Abacus Cities	Dec 31/75	16,658	17,215	2,876	1,526	3,529	2,635	109.5	57.9
Douglas Leaseholds	Dec 31/75	13,508	1,373	340	145	5,329	4,612	7.4	3.1
		6,675,078	1,800,960	254,746	126,070	904,453	852,917	29.9	14.8

NOTES: 1. MEPC's total assets at October 31, 1976 were $186.8 million.
2. Includes investment in Carma.
3. Returns are after subtraction of preferred dividends.
4. Excludes non-real estate related sales of $30.4 million.
5. Excludes gross revenues from brokerage, and mortgage portfolio of $48 million.
6. Excludes non-real estate revenues of $50 million.
7. Includes investment in Y & R and Imperial General.

SOURCE: Reprinted from Gluskin, 1976. p. 58.

TABLE 14: After Tax Return on Equity, Major Public Development Companies (Per Cent)

	1975	1974	1973	1972	1971	1970	1969	1968	1967	1966
Bramalea	13.5	8.0	11.8	8.6	−0.3	−2.3	11.0	9.1	12.6	7.7
Cadillac Development[1] (Cadillac Fairview)	11.9	11.0	16.2	11.9	11.0	11.0	16.1	7.4	23.7	—
Consolidated Building	13.3	28.1	26.1	29.7	17.5	18.3	−1.9	10.3	3.3	2.6
Markborough Properties	11.1	10.3	20.0	4.1	2.5	3.4	4.1	2.2	0.8	−0.4
S.B. McLaughlin	—	7.8	12.1	27.7	34.4	3.8	10.9	18.3	—	—

NOTES: — not available.
1. Data for 1974 and 1975 are for Cadillac-Fairview Corp. The Cadillac Development year end was changed form December 31 to February 28 upon amalgamation.

SOURCE: Computed from Annual Reports and Financial Post Corporation Service. As found in Muller, 1978, Table 34, p.113.

TABLE 15: Profits After Tax on Equity, Nine Industrial Divisions, Canada 1968-1973 (Per Cent)

	1968	1969	1970	1971	1972	1973
Agriculture, Forestry and Fishing	6.3	6.2	5.5	3.5	6.1	13.6
Mining	8.4	8.3	7.8	6.0	4.5	10.7
Manufacturing	8.1	8.6	6.2	7.7	8.7	12.8
Construction	10.6	9.3	6.4	9.8	9.5	12.0
Transportation; Communications and other Utilities	5.1	5.2	5.1	5.7	6.1	6.4
Wholesale Trade	8.2	8.6	7.2	9.8	10.1	12.1
Retail Trade	8.6	7.6	a	a	a	a
Finance	7.4	6.6	4.4	6.1	5.1	5.7
Services	10.3	17.0	5.8	6.9	7.0	8.3
Total	7.7	7.5	6.3	7.4	7.2	9.5
Real Estate Operators and Developers	7.6	7.2	5.3	6.4	7.0	8.3
Weighted Average, Five Major Public Development Co.	6.4	10.2	5.0	9.5	12.8	13.9

NOTE: (a) The inclusion of results for provincial liquor agencies had distorted these data to the point of uselessness.

SOURCE: Statistics Canada (61-207) and private correspondance, Table 4.1. As found in Muller, 1978, Table 35, p. 114.

> Toronto area, it is probable that their profit rates are above average for developers in the same region. It is certainly true that the reported rate of profit of the five greatly exceeds that of the category Real Estate Operators and Developers which was 7.0 percent over the six years and which was consistently below the mean for all corporations. There is a clear indication of substantially above average rates of return in 1972 and 1973. To the extent that the accounts of these five companies reflect conditions in the Toronto housing market, it is clear that large short-run profits were being earned in that period. (pp. 112, 115)

Muller (1978) suggests the profit rates reported in Table 14 are inadequate indicators of the profits earned in the Toronto housing market for several reasons:[33]

> 1. The coverage of any sample of reported financial results is incomplete because profit data are not available for private companies (no public shares); it is impossible to segregate the earnings of the large public corporations in the Toronto area from their non-residential developments and other investment portfolio activities.
>
> 2. The after-tax rate of return (accounting rate of profit) is deficient with respect to: inadequate treatment of unrealized capital gains, particularly on land inventories, inadequate reporting of the benefits of deferred taxes and depreciation allowances, sensitivity to the accounting treatment of certain items, and failure to identify profit taken in the form of high compensation payments to senior officers and directors.[34]

Muller (1978) also notes that the data for both tables are based on the published accounts of the respective companies and should be cautiously interpreted for the above reasons.[35]

33. Four of the five firms' development emphasis was on single family residences.

34. See Muller (1978, pp.115-119) for a discussion of these. There is little agreement on the most appropriate measure of profit rates. Many of the studies cited in this Appendix present some discussion. For example, see Lorimer (1978, Chapters 3 and 6), MMAH (1982, Chapter 4) and Muller (1978, pp. 112-119).

35. With respect to Table 15 (and Table 5 in section 2.1) definitional considerations likely affect the reported profit rates as adequate indicators of true profit in residential rental investments. See the Source note to Table 17 (below).

Table 16 reports the internal rate of return on shareholders' investment for the same five public real estate companies as in Table 14.[36] Muller (1978) makes the following observations:

> It will be seen that on a year to year basis, internal rates of return are somewhat higher than the corresponding return on equity, largely because the previous year's equity is the denominator. Over the long run, three firms have consistently provided after-tax returns much higher than prevailing interest rates, and the two smaller companies, Consolidated and S.B. McLaughlin, have shown after-tax internal rates of return over a five year period well in excess of 20 per cent per annum. However, the return on Bramalea for most years since about 1970 is well below the conventional mortgage rate. In general, profit rates are highly variable between firms and over time for a given firm. All firms did very well during the period 1972-1974 and some of them (such as Consolidated) did make spectacularly high profits during that period. (p. 122)

Muller (1978) concludes with the following comments:

> The data seem strong enough to identify a period of very high profits in the Toronto housing market between (say) 1971 and 1974. There is little evidence of excessive rates of profit on average over the period 1966-70. Thus it cannot be claimed that there is evidence of long term restrictions on entry in the industry. The high rates of profit experienced in the later period create a presumption that output of new housing should have been expanded. Whether the binding constraint was the planning approval process or the market power of developers cannot be determined from the data. Indeed it is possible that neither constraint was binding and that the rising prices were due primarily to the inelasticity of the short-run supply of new housing. (pp. 122-123)

Another study which used aggregate industry level data is Kalymon (1978). He examined the historical rate of return on real estate investment in two periods: 1969-70, a period of low inflation, and 1973-74, when inflation rates were substantially above the historic average. For the all industries category, income as a per cent of equity was 9.37 in 1969 and 15.04 in 1974 (Table 17). For real estate, the figures were 10.51 and 14.79 per cent respectively.

36. For a discussion of the reasons why Muller chooses the internal rate of return as a preferred profitability measure see Muller (1978 p. 119). See also Gau (1983, pp. 30-31).

TABLE 16: Internal Rates of Return For Five Development Corporations 1966-1975

Bramalea Ltd.

Fiscal Year Ending Nov. 30	To 1967	1968	1969	1970	1971	1972	1973	1974
1966	14.9	14.4	13.6	8.8	6.5	7.0	8.2	8.2
1967		13.9	13.1	7.2	4.9	5.9	7.4	7.6
1968			12.5	4.9	2.8	4.5	6.4	6.8
1969				−2.2	−1.7	2.0	5.0	5.8
1970					−1.1	4.4	7.5	7.8
1971						9.4	11.8	10.8
1972							14.3	11.4
1973								8.7

Cadillac Development Corp.

Fiscal Year Ending Dec. 31	To 1968	1969	1970	1971	1972	1973
1967	9.9	14.9	13.7	13.3	13.2	14.2
1968		17.9	14.8	14.0	13.7	14.8
1969			11.6	11.9	12.3	14.8
1970				12.1	12.6	14.8
1971					13.2	16.1
1972						19.0

Consolidated Building Corp.

Fiscal Year Ending Nov. 30	To 1968	1969	1970	1971	1972	1973	1974	1975	1976
1967	−8.0	1.3	−3.6	2.3	5.4	11.2	18.5	21.3	20.2
1968		11.4	−1.3	6.0	9.0	15.5	23.5	25.8	23.7
1969			−12.7	3.4	8.2	16.7	26.1	28.1	25.3
1970				22.4	20.5	28.2	38.1	37.0	31.5
1971					18.6	31.2	43.7	40.3	32.9
1972						45.1	57.8	46.7	35.6
1973							71.0	47.3	33.6
1974								34.5	24.1
1975									14.5

Markborough Properties

Fiscal Year Ending Dec. 31	To 1967	1968	1969	1970	1971	1972	1973	1974	1975
1966	11.9	2.2	3.0	3.2	3.0	3.3	6.7	7.4	8.0
1967		2.3	3.3	3.3	3.2	3.5	7.0	7.7	8.3
1968			4.2	3.9	3.4	3.7	8.0	8.6	9.2
1969				3.5	3.0	3.6	8.9	9.5	10.0
1970					2.6	3.6	10.7	11.0	11.3
1971						4.6	14.8	13.7	13.4
1972							25.1	18.1	16.2
1973								11.6	12.1
1974									12.5

S.B. McLaughlin

Fiscal Year Ending Dec. 31	To 1967	1968	1969	1970	1971	1972	1973	1974
1968			15.5	5.6	26.5	31.1	27.8	22.8
1969				−0.2	30.5	34.7	29.8	23.5
1970					70.5	54.3	39.8	28.5
1971						42.1	29.3	20.4
1972							18.4	12.7
1973								8.5

SOURCE: As found in Muller, 1978, Table 37, pp. 120-121.

TABLE 17: Financial Results in Real Estate Compared With All Industries (Other Than Financial)

	All Industries (Non-financial)				Real Estate Operators and Developers[1]			
				(Million $)				
	1969	1970	1973	1974	1969	1970	1973	1974
1. Income Reported	4,706	4,119	9,766	12,333	254	228	424	686
Percent of Equity	9.37	7.75	13.43	15.04	10.51	8.58	11.29	14.79
Percent of Equity Less Inflation	4.77	4.45	5.83	4.24	5.91	5.28	3.69	3.99
2. Income Adjusted by Inventory Profits and Understated Depreciated	3,885	3,500	7,667	8,125	229	206	288	391
Percent of Equity	7.73	6.58	10.55	9.92	9.46	7.75	7.67	8.43
3. Income Adjusted by Inventory Profits and Understated Depreciation	2,855	2,202	4,559	3,296	69	33	(59)	(152)
Percent of Equity	5.68	4.14	6.27	4.02	2.85	1.24	(1.57)	(3.28)
4. Income + Depreciation + Deferred Taxes	9,075	8,847	16,768	20,939	522	515	930	1,207
Percent of Equity	18.07	16.64	23.09	25.54	21.50	19.33	24.78	26.02
5. Dividends Paid	2,004	2,248	3,475	4,526	83	85	225	298
Percent of Equity	3.99	4.23	4.78	5.52	3.41	3.21	6.00	6.43
6. Income as Percent of Capital Employed	5.8	4.7	7.3	8.1	2.4	2.0	2.9	3.3
Consumer Price Increases	4.6	3.3	7.6	10.8				

NOTE: 1. Statistics Canada's definition of ''real estate operators and developers'' — establishments primarily engaged in owning and operating real estate or in developing or improving unimproved real property. this includes operators of non-residential buildings, apartment buildings, trailer sites of a ''permanent'' nature, other dwellings, owners of agricultural, forest, mining, railroad, public utility and other kinds of real property which are rented out to the operators. This industry includes establishments primarily engaged in subdividing and developing real estate.

SOURCE: Corporation Financial Statistics, Statistics Canada, as found in Kalymon, 1978, Table 4, p. 18. Statistics, Statistics Canada, as found in Kalymon, 1978, Table 4, p. 18.

With income adjusted by removing inventory profits resulting from inflation, the all industries figures were 7.73 and 9.92 per cent. For real estate the returns were 9.46 and 8.43 per cent. Kalymon suggests that "the returns on equity invested in the real estate industry were very similar to those achieved by industry in general." (p.17)[37]

3. Discussion

It appears that large real estate corporations were doing quite well in the period just before the introduction of rent control in Ontario. Gluskin (1976) showed that:

> The total industry [based on 23 firms] itself had a cash flow return on total assets of 6.4% in 1975, and 29.5% cash flow return on equity and 14.8% in terms of net profits. (p. 187)

However, four of the five most profitable firms were active in the development of shopping centres, while two of the five least profitable had residential apartments as the mainstream of their portfolios. Findings for Cadillac Fairview, which was the primary focus of the study, were that:

> As a percentage of total investment in rental properties, cash flow from residential rentals was 3.9% in 1976 compared with 3.0% for office buildings, and 7.2% for shopping centres. (p. 115)

Although a similar breakdown is not available for the 23 firms studied, it is quite likely that Cadillac Fairview's high cash flow return on shopping centres was typical. If so, the cash flow return on equity would have been somewhat less than the overall 29.5 per cent return. Nevertheless, it is probable that the 23 companies surveyed earned in excess of the 18.8 per cent which would have been necessary to give them a return of eight percentage points more than the 1975 inflation rate of 10.8 per cent. Those findings are in line with the realized after-tax returns computed by Gau (1983) for complete holding periods for a sample of commercial and residential rental properties sold in Vancouver in 1979. He found that the mean value of the after-tax rates of return on total investment (debt and equity) was 10.3 per cent. Taking leverage

37. A critique of the Kalymon study by R. Decker forms part of the published study. He contends that real estate is a generic term encompassing heterogenous real estate activities. Because of this, Decker argues assets and income should be segmented according to type of real estate activity in order to conduct comparative analysis with other industries. Without this segmentation, measurement problems will likely arise. See "A Dissenting Opinion" by R. Decker *in* Kalymon (1978, pp. 31-41).

into account, equity investors earned on an annual basis, average after-tax rates of return of between 21.1 and 24.4 per cent on apartments (depending on the assumption made concerning tax-sheltering benefits) and between 19.0 and 19.7 per cent on commercial properties. Gau notes that price appreciation was an important component of these returns. Those findings cannot be related to the inflation-linked required return since buildings were held for different periods. The important contribution of Gau's work is that it takes into full account capital appreciation of the properties. Gluskin's calculations do not reflect unrealized capital gains.

Muller (1978) studied the profitability of investment in rental housing in the Toronto area during the 10-year period (1966-75) prior to the introduction of rent controls based on data for five public real estate companies. He found the mean return on equity during the six years 1968-73 was 9.6 per cent for developers and 7.6 per cent for all corporations. The difference between the return earned by developers and that earned by all corporations is less than one percentage point more than the premium required to compensate for additional risk of investment in real estate, as estimated by Quirin (1986).[38]

The 1982 study done by Price Waterhouse for the Ontario Ministry of Municipal Affairs and Housing in 1981 compared returns in 1975 and 1980 for a sample of 68 rental buildings. The study observes that in general the sampled buildings:

> . . . did not perform strongly relative to their landlord's targets, the rate of inflation, the returns in other industries or the stock market. They did, however, perform better than investors in the bond market. (p. 85).

The P-W study did not determine the required rate of return as a basis for assessing the performance of the landlords surveyed. However, Table 3 shows that for the period 1971 to 1980 the average rate of cash on cash return (or return on book value of the equity) was 4.8 per cent while the inflation rate averaged 8.1 per cent. Furthermore, the annual returns (see the Average NOI rate in Table 3) were fairly stable throughout the period. Hence, that rate of return is representative of both the pre-control and the post-control periods.

38. Quirin (1986) shows illustrative values of the components of the investors' required rate of return for long-run investments under alternative inflation and interest rate scenarios in Table 3-A2. "Compensation for risks borne by equity investors in large corporations" is in the 5.5 to six per cent range. On page 222, Quirin estimates the risk exposure of real estate investors to be 20 to 30 per cent greater than that of the TSE 300. Hence, the risk premium for developers relative to all corporations may be estimated to be in the range of 1.1 to 1.8 per cent which is slightly below the two per cent actual premium for developers estimated by Muller for the 1968-73 period.

Furthermore, the average return for the sample of rental buildings was below the required return for the 1971 to 1980 period. Using Quirin's (1986) methodology and the data presented in Table 4, it can be determined that the risk-adjusted required rate of return would be 16.9 per cent.[39] It also may be noted that Table 5 shows the return on capital for the sample buildings (5.4 per cent) was substantially below the return earned by industry (11.7 per cent) in general over the same period of time.

As noted earlier, Quirin's (1986) estimate of the required rate of return is probably somewhat low. If a high required return is used as the test for excess profits, for example if Kalymon's (1978) risk estimate which suggests a 2.4 percentage point higher risk premium is used, then the estimates of excess profits earned by the rental housing industry would be reduced.

4. Concluding Comments

This Appendix, in reviewing the available information on rates of return on residential rental investments, has examined two aspects. First, reported estimates of the minimum rate of return on investment sufficient to attract private investment into the rental housing market were reviewed. Second, estimated actual rates of return on rental investment were reviewed. With respect to the first, Kalymon (1978) estimated for the 1973-1974 period a minimum rate of return of 17.85 per cent. Quirin (1986) estimated the required rate of return, as of early 1985, to be between 17.1 to 19.5 per cent. As noted earlier since the large corporations in these estimates are likely able to diversify risk, the estimated required rate of return may be low relative to that for the entire industry including small landlords.

The evidence, which pertains only to large developers, indicates that the industry earned a rate of return on equity above the competitive rate of return in some time periods and below it in other time periods. To summarize, 23 Ontario firms had a pre-tax return (net profit) on equity investment in 1975 that was 10.7 percentage points above the estimated required return. It should be noted that 1975, the year rent review was introduced in Ontario, was viewed as a time when rents were moving up relatively rapidly; hence, returns probably were relatively high. Over the 1968-73 period, Muller (1978) estimates actual returns that exceed the adjusted required rate of return by less than one percentage point (see footnote 32). The P-W study of Ontario landlords showed that for the period 1971 to 1980 the average rate of return on equity was 12.1 percentage points below the required rate. In Vancouver in 1979, another time

39. Using Quirin's figures, the required return is 28 per cent more than the difference between the TSE 300 Index (15.4 per cent) and the risk-free rate (5-Year GIC's averaged 9.4 per cent). Hence, the required return derived from P-W data using Quirin's methodology is $9.4 + ((15.4 - 9.4) \times 1.25) = 16.9$ per cent.

and place that was considered to be particularly profitable for landlords, investors in apartments earned about six per cent above the required rate of return.

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Appendix F

Vacancy Rates in Ontario

Introduction

This Appendix provides a review of vacancy rates in Ontario. It begins with background information on the role of vacancies in rental housing markets. The second section briefly discusses various measures of vacancy rates as recorded by Canada Mortgage and Housing Corporation (CMHC) in their semi-annual rental apartment vacancy surveys. Section three reviews the data on vacancy rates in Ontario. The final section discusses the representativeness of the CMHC survey in relation to vacancies in the entire rental housing market.

1. The Role Of Vacancies

The rental housing vacancy rate is the number of housing units which are unoccupied and available for rent expressed as a percentage of the total rental stock.[1] It is one measure of the availability of rental housing or of the relative balance between demand and supply. According to Muller (1986) the market is in balance or housing is available when households "can easily obtain accommodation suitable to their needs at the prevailing rent for housing of similar size and quality." (pp. 53-54). The ready availability of rental housing of all sizes and quality levels is considered to be essential for the efficient use of the housing stock. Muller (1986) says:

> When suitable accommodation is not readily available, households will tend to insist on remaining in their current, "unsuitable" homes.

1. As is discussed in subsequent sections vacancy rates are available for various submarkets and at various levels of disaggregation.

> For example, couples whose children have left home will be inclined to remain in excessively large apartments or houses. Similarly, when housing is unavailable, households presented with employment opportunities distant from their present homes may be unable to accept them without incurring high or prohibitive commuting costs. (p. 54)

Housing analysts suggest that when the housing market is stable and balanced, vacancies are at their natural or optimum level. Estimates of the natural vacancy rate range from two to five per cent. Smith (1974) obtained estimates of five per cent for Toronto, Winnipeg and Vancouver. Lett (1976) and Marcuse (1979) refer to five per cent rates for American cities. More recently, Clayton (1984a, p. 14) comments:

> A vacancy rate of 2 to 3 per cent in the Canada Mortgage and Housing Corporation's semi-annual survey has been regarded as indicative of a balanced rental market.[2]

Vacancies at their natural level serve as a buffer stock against changes in rent levels and the ''frictions'' of moving.[3] Tenants can easily find other accommodation, for example, if they receive notice of a large rent increase. Landlords have an optimal inventory of vacant units. Muller (1986) considers vacant apartments similar to empty tables in a restaurant. He comments:

> Consider the analogy of a restaurant. While some find it worthwhile to maintain such low prices that there is always a queue to get in, others charge higher prices and usually have a table available. Some tenants will always be willing to pay slightly more for immediate occupancy. (p. 112, Note 5)

Rosen and Smith (1983) suggest:

> In a manner analogous to the labor market, the housing market requires some normal stock of vacant units to facilitate the search processes of buyers and sellers in the market. These processes and the ''unpredictability'' of demand fluctuations lead suppliers of rental housing to desire to maintain an inventory of unrented units. (pp. 781-782)

2. See also Muller (1986, p. 112) and Rosen and Smith (1983).

3. The ''frictions'' relate to transactions and search costs. These aspects are reviewed in Adams, Ing and Pringle (1986), Hulchanski (1984), Stanbury (1985) and Steele and Miron (1984).

Marcuse (1979) describes the importance of vacancies.[4] He says if the vacancy rate is low:

> . . . there is an absolute shortage of units. There needs to be a certain excess of units available compared to households to permit any significant number of households to move since all households will not move simultaneously and instantaneously, trading units with the precision of a corps de ballet. (p. 128)

Further, he comments that vacancies below the natural level indicate a scarcity of supply — the consequences of which will be rent increases. (p. 128) On the other hand several studies argue that because of such factors as tenure discounts,[5] imperfect revenue and cost information, and the negative effect of potential unwanted vacancies, rents are adjusted imperfectly and only with considerable lags.[6]

Vacancies above the natural level may lead to rent reductions, a greater number of units for tenants to choose from, some conversions out of rental and a decrease in new construction until a new balance is obtained. In a few instances, as noted by Stanbury and Vertinsky (1986), "a high vacancy rate may not be indicative of a housing market favourable to tenants," (p. 6-85) particularly at a submarket or neighbourhood level:

> The units may be in delapidated buildings, in neighbourhoods that are riddled by crime, and consist of units of the "wrong" size for the present characteristics of most households. (p. 6-85).

Also, a high vacancy rate,

> . . . may be a symptom of an economically declining area: while the housing stock remains constant in the short run (even for several years) demand is falling in response to declining population or the number of separate households. (Ibid)

4. As cited in Stanbury and Vertinsky (1986, p. 6-85).

5. Tenure discounts are reduced rates of rent increases or reductions in rents for existing long-term tenants.

6. See for example, Clayton (1984a), Rosen and Smith (1983), Stanbury (1985). The relationship between vacancy rates, rent increases and changes in supply is examined in Clayton (1984), Hulchanski (1984), Muller (1986), Rosen and Smith (1983) and Stanbury and Vertinsky (1986).

Nevertheless, even in these unusual circumstances, the higher vacancy rates likely will yield rent savings to tenants in the short run until the normal supply adjustment process results in a new, balanced market.

Vacancies are a residual of the interaction of demand and supply. In particular, vacancy rates above or below their natural level will be affected by many of the same factors causing changes in demand and supply. Analyses of these factors are extensive.[7] Certainly, on a local or regional basis, besides external factors such as interest rates and government housing policy, local market conditons will lead to varying vacancy rates among centres.

2. Measuring The Vacancy Rate

Data on vacancy rates in privately initiated[8] apartment buildings containing six or more self-contained dwelling units are available through Canada Mortgage and Housing Corporation's semi-annual vacancy surveys.[9] Currently, about 23 census areas[10] are surveyed in Ontario in April and October. Information is obtained through interviews with owners and building superintendents. For survey purposes, a vacancy is "a dwelling unit that is available for immediate rental and physically unoccupied at the time of enumeration."[11] Units in buildings completed within the six months preceding the survey date are excluded to allow for rent-up or market absorption. Since October, 1981, CMHC has distinguished vacancy rates by building age. Units in buildings completed and on the market between seven and 18 months comprise the

7. Chant (1986), Clayton (1984a), Ekos (1985), Environics (1985), Foot (1986), Hulchanski (1984), Marks (1984), Mascall (1985), Muller (1986), Pringle (1986), Slack and Amborski (1984), Stanbury (1985), Stanbury and Vertinsky (1986) and Steele and Miron (1984), in studies completed for this Inquiry, to varying degrees, consider these factors in light of the issues addressed in their studies.

8. The focus of this appendix, as with the survey data, is on vacancy rates in the private sector. However, vacancy rates in the publicly initiated buildings are available. See section 3.7.

9. Statistics Canada publishes vacancy rate estimates for the entire rental market based on Census of Canada vacancy results. CMHC data is considered more reliable and is more widely
used. For a discussion of some of the differences between the two surveys see Clayton (1984b pp. 14-15).

10. The number of centres surveyed has been expanding. In October, 1985, a total of 23 urban centres were surveyed. These included 10 CMA's — the largest urban core areas with populations greater than 100,000, nine Census Areas (CA's) — urban areas with populations between 10,000 and 99,999; and four smaller centres. The largest data series for analytical purposes contains the 10 CMAs. Accordingly, the data presented in section 3 emphasize results for the CMA's.

11. CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, October, 1985, p. 1.

"new" universe; all of these buildings are surveyed. Units in buildings on the market for 19 months or longer form the "old" universe and are surveyed on a sample basis. The "regular" survey universe combines units in buildings in these "old" and "new" universes. This vacancy rate is the accepted measure of vacancies in the existing rental stock after allowing a reasonable time for rent-up. Within the Toronto CMA, for example, in October, 1985, of an estimated universe of 280,569 privately initiated units in buildings with more than six units, 235,391 units (or 84 per cent) were sampled. The "overall" vacancy rate includes all structures surveyed plus those on the market less than six months. It identifies total availability without allowance for rent-up. Published survey results include vacancy rates for apartment units by structure size, by period of construction, by number of bedrooms and by subsectors, or geographical submarkets of the survey area.

3. Vacancy Rates In Ontario

3.1 Overview

Table 1 presents vacancy rates for the 10 CMAs in Ontario. As shown, the vacancy rates are averages of the twice yearly surveys. The longest series are for Toronto and Hamilton. Results for most other centres have been available since 1971.

There is considerable variation in vacancy rates, both over time and across the metropolitan areas. For example, as noted in Muller (1986), between 1965 and 1975, vacancy rates in the Toronto CMA ranged from 1.2 to 3.3 and in 1973 rates ranged from 1.8 in Toronto to 10.5 in Sudbury. Certain centres such as Sudbury and Windsor with specific industries — mining in the former and automobiles in the latter — as the principal element of their economic base appear to show particular vulnerability to economic downturns. For example, many centres in Ontario had somewhat higher vacancy rates around 1980-1982 than in the immediate preceding years. However, over that three year period Windsor, with annual vacancy rates of 4.9, 7.7 and 5.2 per cent, was considerably higher.

There is also variation in vacancy rates within the large CMAs. For example, in October, 1985, in the Toronto CMA, although low in general, vacancy rates range from 0.1 in Etobicoke and North York to 2.7 per cent in the Brampton area north and west of the core metropolitan area (Table 2).

A second observation is that vacancy rates have been lower since the beginning of rent regulation than before. Except for Hamilton, all the centres in Table 3[12] had "average vacancy rates above 2.0 per cent in the pre-

12. Derived following Muller (1986, Table 2.13). Updated to the end of 1985, with some minor corrections and, in the case of the annual data, rounded off to one decimal place.

TABLE 1: Vacancy Rates(1) in Metropolitan Areas, Canada, 1965-1985 (Percent)

Area	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Ontario																					
Hamilton	1.4	1.5	1.4	1.9	1.3	2.2	2.2	2.2	2.3	1.9	2.4	3.1	4.3	3.9	2.5	1.5	0.9	0.6	1.0	0.7	0.4
Kitchener	—	—	—	—	—	5.4	6.3	3.3	4.5	5.1	2.7	3.0	2.9	2.7	2.3	1.7	1.2	1.0	1.6	0.7	0.4
London	—	—	—	—	4.0	4.9	4.4	6.0	6.5	4.4	2.8	2.3	1.9	2.2	4.3	5.0	2.9	2.8	3.1	1.7	0.7
Oshawa	—	—	—	—	—	—	—	—	—	—	—	—	1.6	1.7	3.1	2.7	0.6	0.4	1.4	0.9	0.1
Ottawa	—	7.7	2.2	1.5	1.5	1.9	1.8	2.0	2.1	3.4	2.3	2.1	1.7	1.5	3.0	3.9	1.4	0.3	0.3	0.3	0.9
St. Catharines-Niagara	—	—	—	—	—	—	—	3.1	4.1	4.7	3.2	2.2	1.4	1.6	1.6	2.2	1.4	1.5	12.0	0.9	0.5
Sudbury	—	—	—	—	—	0.3	0.3	5.2	10.5	6.9	2.1	1.2	1.2	5.4	8.5	2.7	1.3	1.1	1.2	0.9	0.8
Thunder Bay	—	—	—	—	—	—	—	0.8	1.4	1.3	0.6	0.3	0.3	1.3	1.6	1.3	1.6	1.1	0.9	0.9	0.5
Toronto	1.6	1.0	1.2	1.5	2.5	2.8	3.3	2.9	1.8	1.1	1.5	1.3	1.1	0.9	1.2	0.8	0.4	0.6	1.1	0.7	0.5
Windsor	—	—	1.1	1.6	0.6	1.4	2.0	2.0	2.5	2.1	3.4	2.5	1.3	1.0	1.4	4.9	7.7	5.2	2.4	0.9	0.7
West																					
Calgary	8.0	5.8	1.6	1.3	1.8	6.3	8.7	7.8	8.3	3.4	1.2	0.3	0.2	1.0	1.0	0.7	0.5	4.1	12.0	11.7	4.8
Edmonton	6.5	2.8	2.8	2.8	3.0	3.8	5.7	6.8	6.8	3.2	0.6	0.1	0.2	0.8	2.5	2.0	1.8	4.0	8.5	10.5	5.9
Regina	—	—	—	—	10.7	10.7	6.6	2.1	1.3	0.4	0.1	0.3	0.8	2.3	2.8	1.4	1.2	0.7	2.4	2.4	3.5
Vancouver	4.0	1.5	1.0	1.3	1.0	2.4	3.5	1.5	0.7	0.2	0.2	0.6	1.6	1.5	0.6	0.1	0.1	1.3	2.0	2.3	2.5
Victoria	—	—	—	—	3.2	5.3	4.1	2.0	0.9	0.3	0.2	0.5	2.8	2.8	0.9	0.1	0.1	1.1	1.9	3.0	2.6
Winnipeg	4.9	4.1	1.7	1.6	1.7	3.0	4.6	4.9	3.8	2.3	1.9	1.5	1.5	2.8	4.8	5.0	3.9	1.8	1.2	0.9	0.9
East																					
Chicoutimi-Jonquiere	—	—	—	—	—	—	—	2.4	1.4	3.0	1.1	1.1	0.7	0.5	2.2	1.8	0.9	3.6	2.9	1.8	2.5
Halifax	5.4	3.8	2.8	0.5	0.6	2.9	3.9	3.3	2.4	2.5	2.1	1.9	2.3	2.3	2.7	1.9	0.7	0.8	1.5	0.7	0.7
Hull	—	3.9	0.8	0.5	1.0	1.5	3.9	4.5	2.8	2.1	3.5	7.4	6.9	6.4	6.3	6.3	2.8	1.3	0.7	0.8	3.4
Montreal	—	4.5	1.2	5.0	6.7	7.3	5.8	4.3	2.9	1.9	0.9	1.0	2.5	4.5	4.5	3.5	2.0	2.2	2.9	2.6	1.8
Quebec	—	4.8	2.2	2.2	2.8	2.9	4.4	5.5	4.1	3.2	1.3	0.8	1.4	2.6	3.8	2.8	1.9	3.3	4.5	2.6	1.4
Saint John	—	—	—	—	0.5	2.3	1.0	1.1	1.2	0.7	0.5	5.8	8.8	7.2	3.2	3.4	3.3	3.5	4.0	4.6	3.7
St. John's	—	—	—	—	17.2	20.7	3.6	0.5	0.3	0.5	2.1	2.5	3.6	9.3	4.0	1.2	1.2	4.4	4.7	3.3	2.9

Note: 1. For privately initiated buildings containing six or more units. Excludes buildings constructed within six months of the survey dates. Data for 1965 to 1968 are for June; thereafter the estimates are averages of the twice yearly surveys.

Source: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, various years.

TABLE 2: Vacancy Rates[1] Within the Toronto CMA, 1980–1985 (Percent)

	1980	1981	1982	1983	1984	1985
Metro Toronto:						
Toronto	0.4	0.4	0.6	0.7	0.6	0.4
Etobicoke	1.1	0.3	0.9	1.1	0.2	0.1
York	0.6	0.3	0.3	0.6	0.4	0.2
East York	0.3	0.0	0.2	0.1	0.2	0.1
Scarborough	0.5	0.3	0.5	0.7	0.3	0.2
North York	0.3	0.2	0.2	0.9	0.3	0.1
Sub Total Metro	0.5	0.3	0.5	0.8	0.4	0.2
Mississauga	0.6	0.3	2.6	2.6	1.7	0.8
Brampton	0.5	0.3	0.4	3.0	3.1	2.7
Oakville	0.3	0.3	0.4	0.5	0.2	0.5
Caledon[2]	—	—	—	—	0.0	0.0
York Region	—	—	—	0.4	0.2	0.1
Ajax, Pickering	—	—	—	2.2	1.2	0.0
Remainder of CMA	0.5	0.3	1.8	2.3	1.6	1.0
Total CMA	0.5	0.3	0.7	1.0	0.6	0.4

NOTES: 1. For privately initiated buildings containing six or more units; October survey results. Excludes buildings constructed within six months of the survey date. 2. Includes Vaughan and King Townships.

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, October, various years.

control period and noticeably lower rates in the post-control period.'' (Muller, 1986, p. 57) Before 1975 only two of the 47 reported vacancy rates were less than 1.0 per cent. In the period from 1976 to 1985, 19 of 60 observations were below 1.0 per cent. Most vacancy rates less than 1.0 per cent have occurred since 1980 (17 of 30 observations, 1981-1985). Muller (1986) concludes:

> Thus one's general impression is that despite short term variation, vacancy rates have been continually declining since the imposition of rent review. (p. 57)

This downward trend-line is evident in Figure 11[13] and particularly so, in Figure 2 which shows vacancy rates in the Toronto CMA.

13. Only four major centres are plotted for visual clarity.

TABLE 3: Vacancy Rates[1] In Selected Ontario Metropolitan Areas, 1965- 1985 (Percent)

Year[2]	Toronto	Hamilton	Kitchener	London	Ottawa	Sudbury
1963	4.4	—	—	—	—	—
1964	2.8	—	—	—	—	—
1965	1.6	1.4	—	—	—	—
1966	1.0	1.5	—	—	7.7	—
1967	1.2	1.4	—	—	2.2	—
1968	1.5	1.9	—	—	1.5	—
1969	2.5	1.3	—	4.0	1.5	—
1970	2.8	2.2	5.4	4.9	1.9	0.3
1971	3.3	2.2	6.3	4.4	1.8	0.3
1972	2.5	2.2	3.3	6.0	2.0	5.2
1973	1.8	2.3	4.5	6.5	2.1	10.5
1974	1.1	1.9	5.1	4.4	3.4	6.9
1975	1.5	2.4	2.7	2.8	2.3	2.1
1976	1.1	3.1	3.0	2.3	2.1	1.2
1977	1.1	4.3	2.9	1.9	1.7	1.2
1978	0.9	3.9	2.7	2.2	1.5	5.4
1979	1.2	2.5	2.3	4.3	3.0	8.5
1980	0.8	1.5	1.7	5.0	3.9	2.7
1981	0.4	0.9	1.2	2.9	1.4	1.3
1982	0.6	0.6	1.0	2.8	0.3	1.1
1983	1.1	1.0	1.6	3.1	0.3	1.2
1984	0.7	0.7	0.7	1.7	0.3	0.9
1985	0.5	0.4	0.4	0.7	0.9	0.8
Averages:[3]						
Pre-Control	2.20	1.81	4.91	5.01	2.67	4.63
Post-Control	0.82	1.87	1.72	2.66	1.52	2.41
Total	1.57	1.87	2.78	3.49	2.07	3.08

NOTES: 1. For privately initiated buildings containing six or more units. Excludes buildings constructed within six months of the survey dates. 2. Data for 1963 to 1968 are for June; thereafter estimates are averages of the twice yearly surveys. 3. Pre-control period is from the beginning of the data series to 1974. Post-control is from 1976 through 1985. Total includes 1975.

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, various years. Derived following Muller, 1986, Table 2.13; with corrections and updated to the end of 1985.

3.2 A Comparative View

Table 1 allows for a comparative view of vacancy rates in Canada; Tables 4 and 5 show vacancy rates in American cities for which data are available. The same information is presented in Figures 3 through 8.[14] For the Canadian centres

14. Two centres have been eliminated in each of Figures 3 and 4 for visual clarity. U.S. data is broken up for visual clarity.

except for Halifax (Figure 4) and possibly Winnipeg (Figure 3) no other centres show the downward trend-line noticeable in the Ontario centres. For example in Figure 3 Calgary, Regina, Vancouver and Edmonton all experienced low vacancy rates (close to 0.0) in the years 1974-1976 then picked up to around 2.0 per cent near the end of the 1970's. Calgary, Regina and Vancouver again had low vacancy rates for the period roughly between 1979 and 1981 (less than 0.5 per cent). They increased thereafter and all of the western cities (except Winnipeg) at the end of 1985 had vacancy rates above 2.0 percent. Despite each centre having its own factors,[15] it would appear that only Ontario centres show this steady decline in vacancy rates. Some of the recent pressure on vacancy rates in Ontario, however, may be the result of return migration from western provinces and other in-migration due to the relatively better economic conditions in Ontario. Vacancy rates in those areas from which people move would tend to increase.

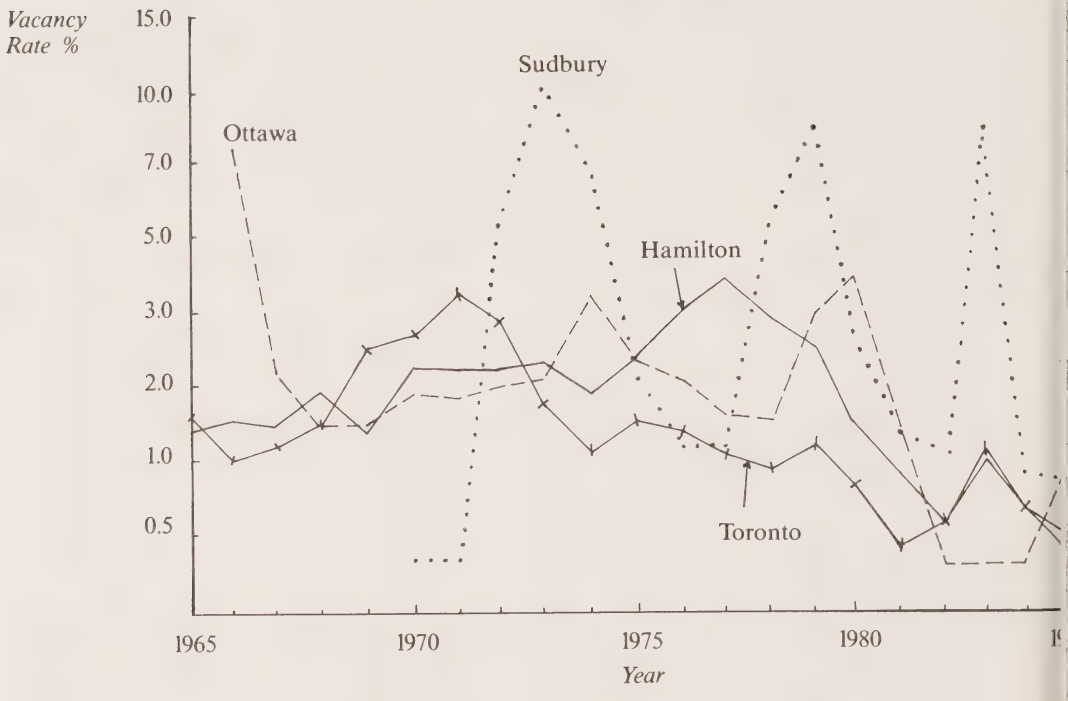
In the U.S. cities, while some centres do show a decrease since about 1978, the absolute level of vacancies is considerably higher than those in Ontario (see Tables 4 and 5, Figures 5-8). For example in Figure 8 both San Francisco and San Diego show declining vacancy rates. However in 1982 when they recorded their lowest level, their vacancy rates were still at or near 4.0 per cent. In part the higher vacancy rate is likely due to units which are available for rent, but not necessarily immediately so, being counted as vacancies (Abt Associates, 1980, p. 19). Delapidated units are also included in the Census Bureau's definition.

Stanbury and Vertinsky (1986) also provide a comparative analysis of vacancy rates. They focus on Ontario and non-Ontario CMAs over the period 1971-1984. They note that both groups experienced similar counts of centres with rates of two per cent or less during the 1976-1980 period (about 58 per cent of all reporting CMAs). Over the 1981-84 period non-Ontario CMAs had higher vacancy rates than did Ontario centres. In Ontario, 85 per cent of CMAs had vacancy rates of two per cent or less; 60 per cent of non-Ontario CMAs were two per cent or less. They found greater variance in non-Ontario vacancy rates. For the most recent period, 13 per cent of non-Ontario CMAs had vacancy rates above 4.1 per cent while only four per cent of Ontario CMAs had similar rates. They conclude:

> It is clear that vacancy rates for both Ontario and non-Ontario CMAs have declined since 1975. However, the data in Table 6-24 indicates that the decline was greater for Ontario CMAs and that the variance in vacancy rates across Ontario CMAs was lower than that across CMAs outside Ontario. (p. 6-90)

15. As noted at the end of section 1.

Figure 1: Rental Vacancy Rates[1] for Selected Metropolitan Areas, Ontario, 1965-1985



NOTE: 1. For privately initiated buildings containing 6 or more units. Excludes buildings constructed within 6 months of the survey dates. Data for 1965 to 1968 are for June, thereafter the estemates are averages of the twice yearly surveys.

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey,* various years.

3.3 Vacancy Rates by Size of Unit and Building

Table 6 shows, for the Toronto CMA, that between 1973 and 1984 one bedroom units followed by two bedroom units had the lowest vacancy rates averaging 0.8 and 1.0 per cent respectively. Bachelor and three bedroom unit vacancy rates were 1.5 and 1.6 per cent respectively. Pringle (1986) makes an observation based on Environics 1984 HOMES survey data concerning unit type preference of potential movers that the majority preferred two bedroom units (60 per cent in Metro Toronto) He notes:

> Only 3 per cent of those in Toronto wanted bachelors and another 14 per cent wanted one bedroom units. These figures suggest that two bedroom units may be scarcest in the near future. (p. 65)

By October, 1984, vacancy rates were 0.8 per cent or less for all unit sizes.[16] Stanbury and Vertinsky (1986) observe:

> At any date of measurement, the absolute vacancy rate for any size of unit never exceeded 3% and the table records [96] observations. In only [16] cases was the vacancy rate above 2%. In short, regardless of the size of the unit, the vacancy rate could only be described as low. (p. 6-96)

Over the period 1973-1984 average vacancy rates in the Toronto CMA appear to have been unrelated to building size (Table 6). Apartment buildings with 200+ units had a slightly higher vacancy rate at 1.3 per cent than the six other categories whose rates ranged from 0.8 to 1.0 per cent. In October, 1984, the building size category of six to nine units was the only one to have a vacancy rate above 1.0 per cent.[17] Stanbury and Vertinsky (1986) conclude:

> There have been no ''pockets'' or segments of moderate to high vacancies in the Toronto rental market either by size of unit or by size of building. (p. 6-96).

3.4 Vacancy Rates by Age of Building

The aggregate vacancy data such as was presented in Table 1 conceal what Muller (1986) calls ''a considerable discrepancy between vacancies in recently

16. In the October, 1985, survey for the Toronto CMA bachelor, one, two and three bedroom units had vacancy rates of 0.6, 0.3, 0.4 and 0.4 per cent respectively.

17. In the October, 1985, survey, from smallest size to largest size category, vacancy rates were 0.9, 0.3, 0.4, 0.2, 0.3, 0.5 per cent respectively.

Figure 2: **Vacancy Rates[1] in the Toronto CMA, 1965-1985**



NOTE: 1. For privately initiated buildings containing 6 or more units. Excludes buildings constructed within 6 months of the survey dates. Data for 1965 to 1968 are for June; thereafter estimates are averages of the twice yearly surveys.

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey,* various years.

The aggregate vacancy data such as was presented in Table 1 conceal what Muller (1986) calls "a considerable discrepancy between vacancies in recently

TABLE 4: Vacancy Rates[1] for Metropolitan Areas, United States, 1970, 1975, 1978, 1982 (Percent)

Area	1970	1975	1978	1982
Patterson-Clifton-Passaic, New Jersey	1.7	3.3	4.3	1.4
New Orleans, Louisiana	8.8	7.8	7.4	8.0
Kansas City, Missouri	10.2	11.3	11.3	8.1
Columbus, Ohio	6.6	10.8	7.5	10.6
Cincinnati, Ohio	6.8	7.0	7.1	6.8
Atlanta, Georgia	6.2	15.0	8.3	7.9
San Francisco, California	4.6	7.2	5.3	4.0
San Diego, California	6.9	5.7	5.8	3.9
San Bernardino-Riverside-Ontario, California	6.6	10.3	13.7	7.6
San Antonio, Texas	9.3	9.6	8.5	7.8
Rochester, New York	5.0	8.6	7.7	3.6
Philadelphia, Pennsylvania	5.0	7.0	8.1	8.4

NOTE: 1. The rental vacancy rate is the number of year-round units for rent as a per cent of the total rental inventory, i.e., all renter-occupied housing units and all year-round vacant housing units for rent or rented, not occupied.

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Housing Reports, Annual Survey*, various years.

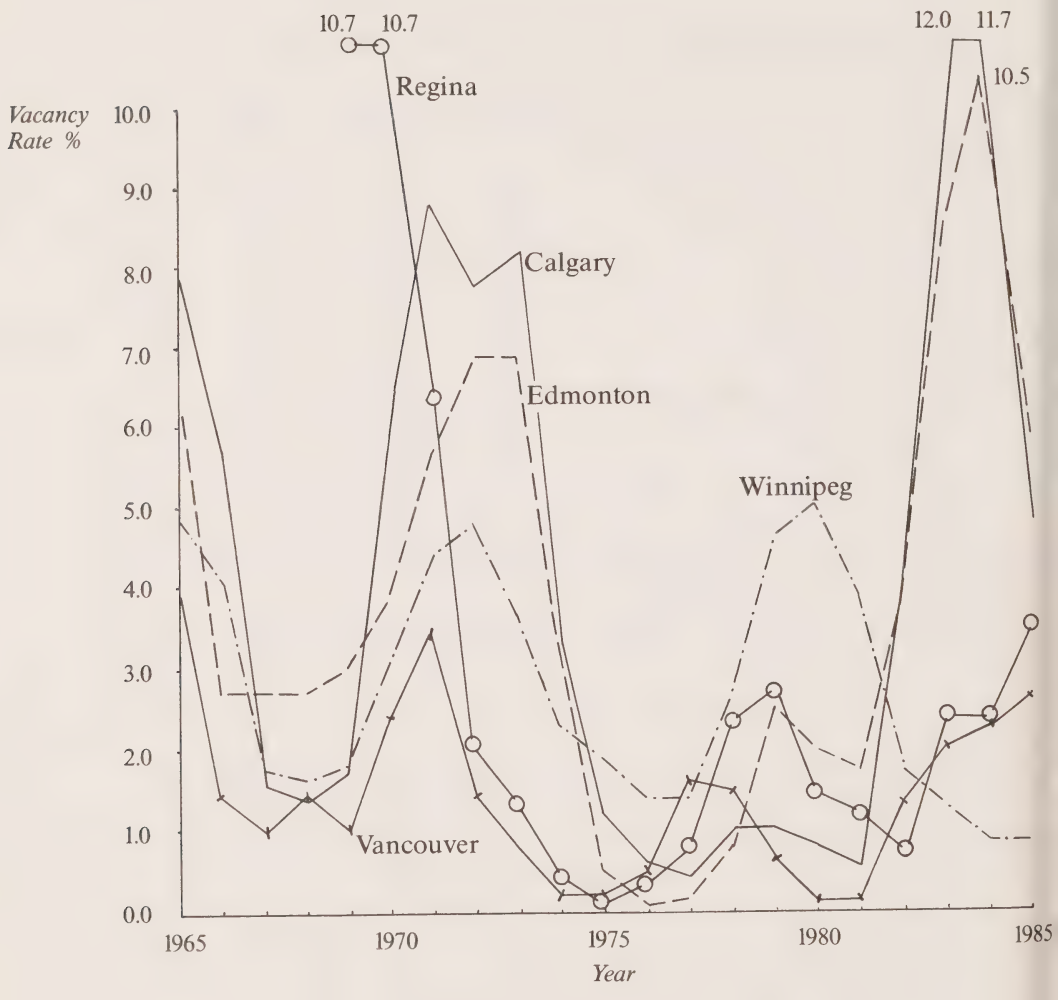
TABLE 5: Vacancy Rates[1] for Metropolitan Areas, United States, 1970, 1975, 1979, 1983.

Area	1970	1975	1979	1983
Chicago, Illinois	6.5	6.7	6.6	6.9
Miami, Florida	5.2	11.1	6.6	9.5
Hartford, Connecticut	3.6	6.8	4.5	4.6
Denver, Colorado	5.2	8.8	6.7	7.7
Portland, Oregon-Washington	7.4	7.1	7.6	8.3
Baltimore, Maryland	5.3	5.2	5.7	6.9
Houston, Texas	11.7	8.0	11.4	17.1
New York, New York	2.2	5.3	4.2	3.7

NOTE: 1. The rental vacancy rate is the number of year-round units for rent as a per cent of the total rental inventory, i.e., all renter-occupied housing units and all year-round vacant housing units for rent or rented, not occupied.

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Housing Reports, Annual Survey*, various years.

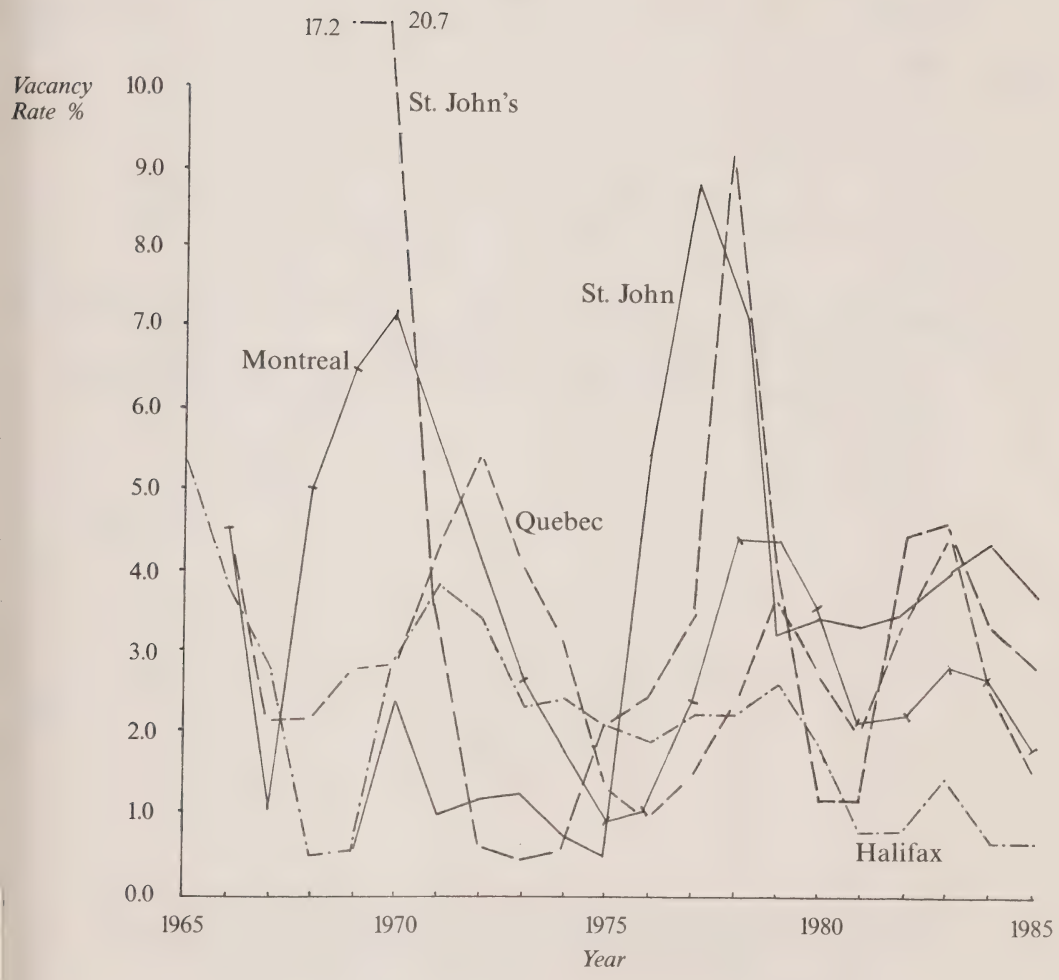
Figure 3: **Vacancy Rates[1] for Selected Metropolitan Areas, Western Provinces, 1965-1985 (Percent)**



NOTE: 1. For privately initiated buildings containing 6 or more units. Excludes buildings constructed within 6 months of the survey dates. Data for 1965 to 1968 are for June; thereafter estimates are averages of the twice yearly surveys.

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey,* various years.

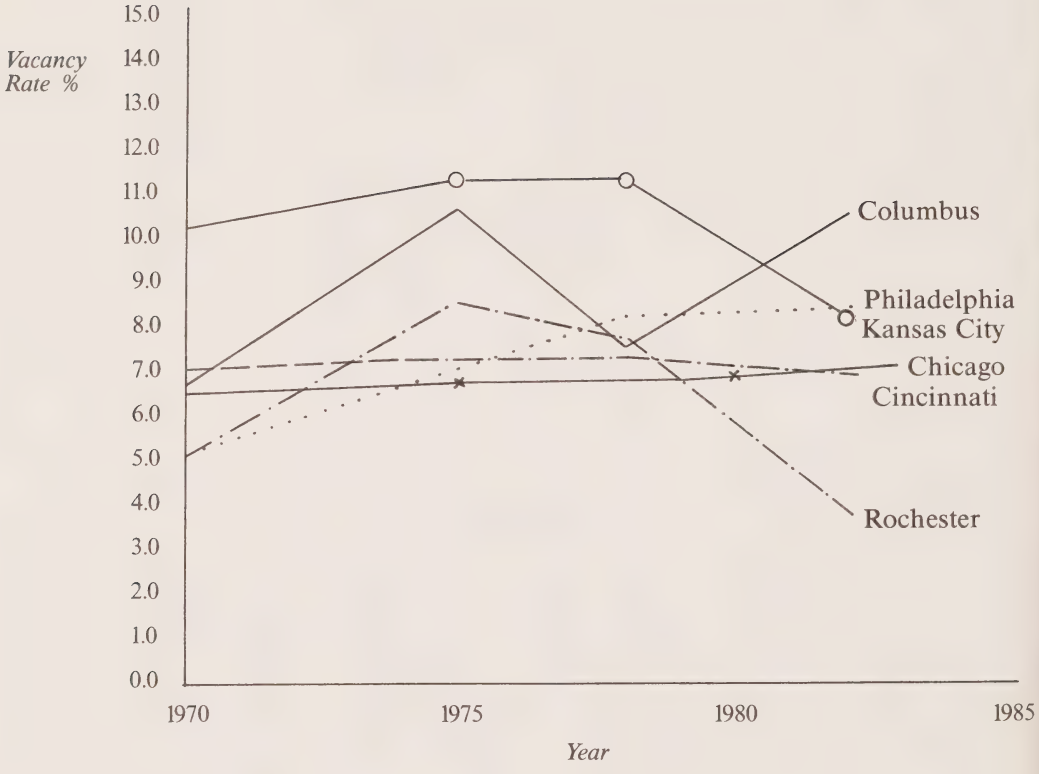
Figure 4: **Vacancy Rates[1] for Selected Metropolitan Areas, Quebec and Maritime Provinces, 1965-1985**



NOTE: 1. For privately initiated buildings containing 6 or more units. Excludes buildings constructed within 6 months of the survey dates. Data for 1965 to 1968 are for June; thereafter estimates are averages of the twice yearly surveys.

SOURCE: CMHC, Toronto Branch, *Rental Apartment Vacancy Survey,* various years.

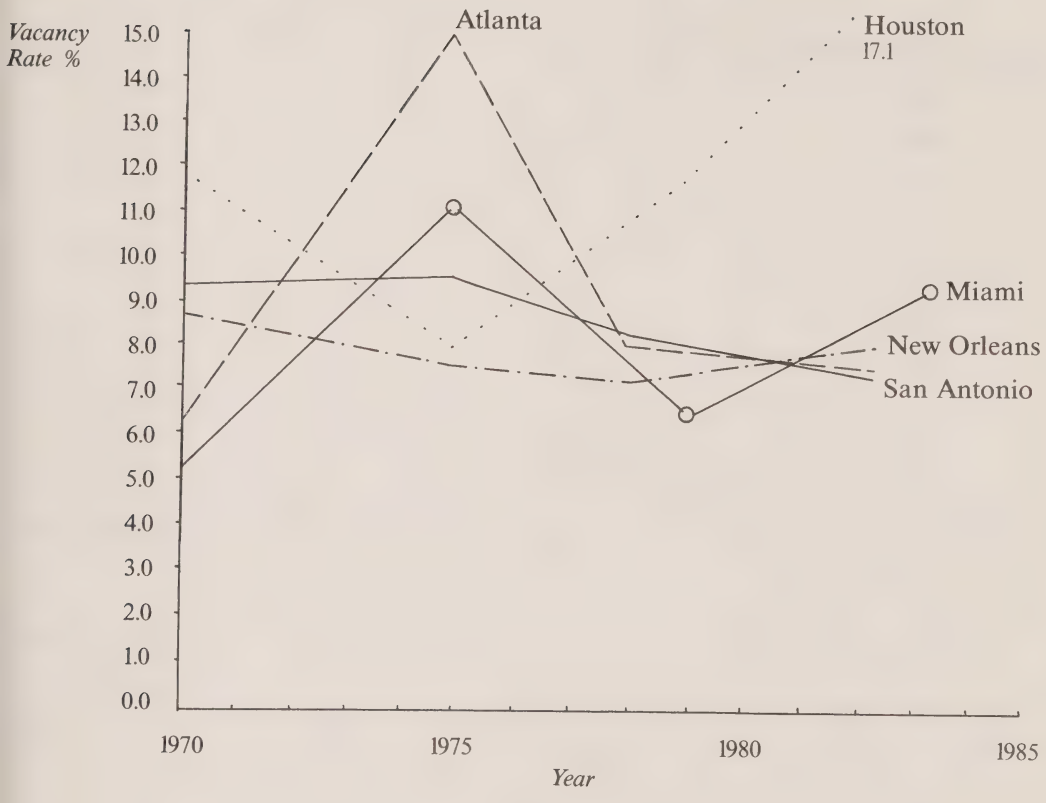
Figure 5: **Vacancy Rates[1] for Metropolitan Areas, United States, 1970-1983 (Percent)**



NOTE: 1. The rental vacancy rate is the number of year-round units for rent as a percent of the total rental inventory, i.e. all renter-occupied housing units and all year-round vacant housing for rent or rented, not occupied.

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Housing Reports, Annual Housing Survey,* various years.

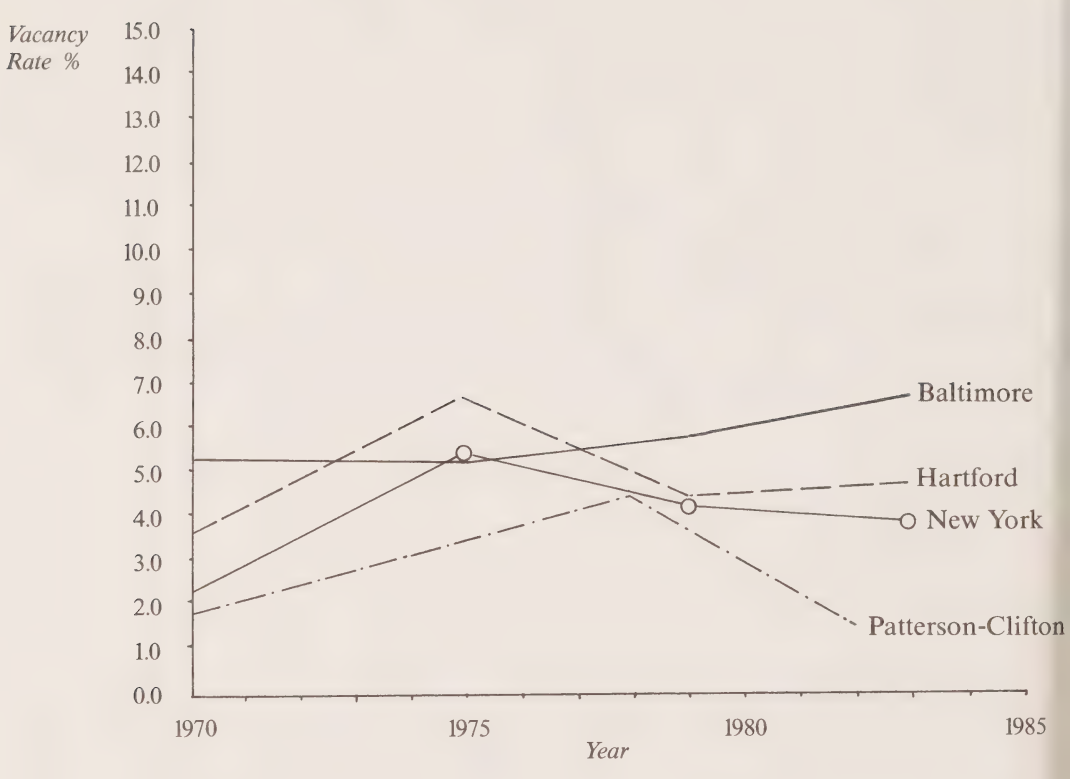
Figure 6: **Vacancy Rates[1] for Metropolitan Areas, United States, 1970-1983 (Percent)**



NOTE: 1. The rental vacancy rate is the number of year-round units for rent as a percent of the total rental inventory, i.e. all renter-occupied housing units and all year-round vacant housing for rent or rented, not occupied.

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Housing Reports, Annual Housing Survey,* various years.

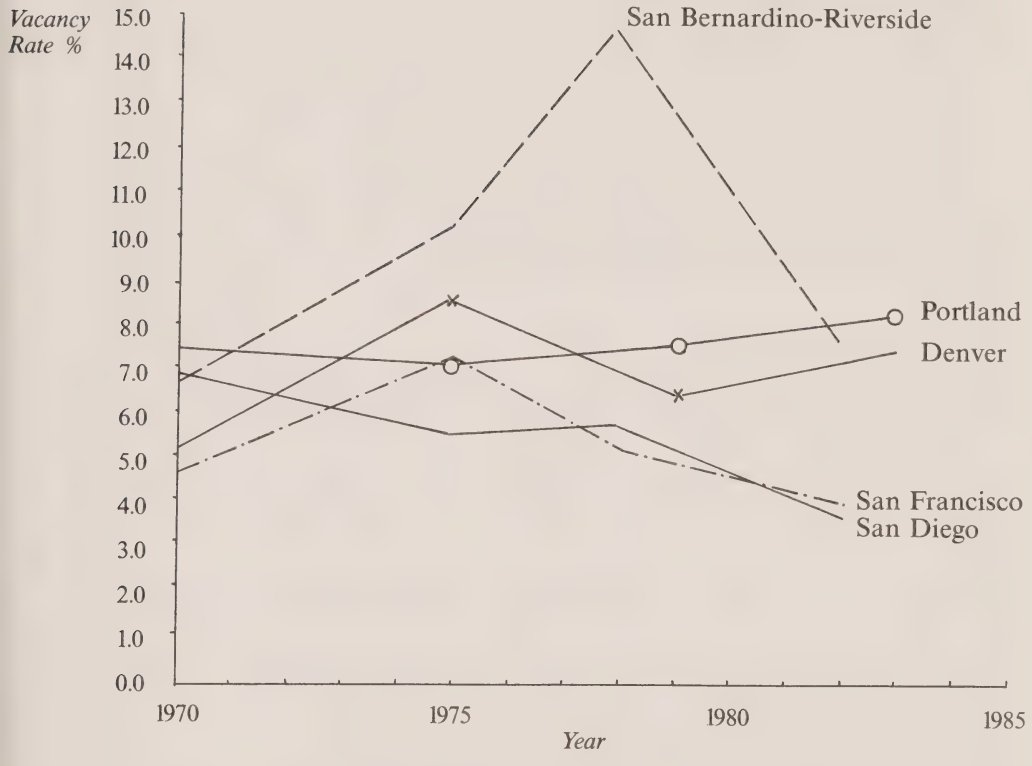
Figure 7: **Vacancy Rates[1] for Metropolitan Areas, United States, 1970-1983 (Percent)**



NOTE: 1. The rental vacancy rate is the number of year-round units for rent as a percent of the total rental inventory, i.e. all renter-occupied housing units and all year-round vacant housing for rent or rented, not occupied.

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Housing Reports, Annual Housing Survey,* various years.

Figure 8: **Vacancy Rates[1] for Metropolitan Areas, United States, 1970-1983 (Percent)**



NOTE: 1. The rental vacancy rate is the number of year-round units for rent as a percent of the total rental inventory, i.e. all renter-occupied housing units and all year-round vacant housing for rent or rented, not occupied.

SOURCE: U.S. Department of Commerce, Bureau of the Census, *Current Housing Reports, Annual Housing Survey,* various years.

TABLE 6: Vacancy Rates[1] by Unit Size and Building Size and Age, Toronto CMA, 1973-1984

	Number of Bedrooms				Structure Size in Dwelling Units							Universe[2]		
	Bachelor	One	Two	Three	6-9	10-19	20-29	30-49	50-99	100-199	200+	Old	New	Total
1973 June	2.4	1.9	2.2	2.2	2.2	1.9	1.2	1.6	1.7	2.0	3.0	2.0	5.0	2.1
Dec.	1.4	1.6	1.5	1.5	0.8	1.5	0.9	1.3	1.2	1.6	2.1	1.5	4.3	1.5
1974 June	2.1	1.1	0.8	0.9	0.8	1.0	1.0	1.1	0.7	0.9	1.6	0.9	4.0	1.0
Dec.	1.3	1.0	0.9	2.1	0.7	0.5	0.6	0.8	0.7	1.0	1.7	0.9	4.7	1.1
1975 Apr.	1.4	1.0	1.0	2.3	0.3	0.4	1.1	0.8	0.9	1.0	1.9	0.9	5.0	1.1
Oct.	2.0	1.6	1.7	2.9	0.7	1.1	1.1	1.3	1.4	1.5	2.8	1.7	4.3	1.8
1976 Apr.	2.0	1.1	1.5	2.2	0.7	1.6	1.1	1.5	0.9	1.4	1.8	1.2	6.0	1.4
Oct.	1.5	1.1	1.2	1.8	0.9	1.1	1.1	1.1	1.0	1.0	1.6	1.0	8.8	1.2
1977 Apr.	2.2	1.0	1.1	1.5	0.7	1.2	1.3	1.4	1.0	0.9	1.5	1.0	11.5	1.2
Oct.	1.6	0.8	1.0	1.4	0.5	0.9	1.3	1.1	0.9	1.0	1.1	0.9	4.9	1.0
1978 Apr.	1.7	0.7	0.9	1.1	0.5	1.1	1.7	1.1	0.8	0.7	0.8	0.9	1.8	0.9
Oct.	1.8	0.6	0.7	1.4	0.9	1.0	0.7	0.9	0.7	0.8	0.9	0.8	7.4	0.8
1979 Apr.	2.5	1.0	0.9	2.1	1.2	1.0	1.9	1.1	0.9	1.2	1.3	1.0	13.2	1.2
Oct.	1.6	0.9	1.0	3.0	1.2	1.2	1.0	1.2	0.8	1.0	1.4	1.0	9.8	1.2
1980 Apr.	2.4	0.6	0.8	2.4	1.9	0.9	1.5	1.1	0.8	0.7	1.2	0.9	6.9	1.0
Oct.	0.9	0.3	0.4	1.4	0.6	0.4	0.6	0.8	0.4	0.3	0.5	0.4	2.5	0.5
1981 Apr.	0.8	0.3	0.3	0.6	0.9	0.7	0.4	0.6	0.3	0.3	0.3	0.4	1.2	0.4
Oct.	0.4	0.2	0.3	0.5	1.4	0.8	0.4	0.4	0.3	0.2	0.2	0.3	0.9	0.3
1982 Apr.	0.7	0.2	0.4	0.8	0.8	0.4	0.5	0.7	0.5	0.2	0.3	0.3	6.1	0.4
Oct.	1.0	0.5	0.7	0.8	0.6	1.0	0.6	0.8	0.6	0.3	0.9	0.5	14.3	0.7
1983 Apr.	1.6	0.9	1.3	1.8	0.7	1.1	0.8	1.5	1.1	1.1	1.4	1.1	14.1	1.2
Oct.	0.9	0.8	1.1	1.5	1.0	0.9	0.5	1.0	0.7	1.1	1.1	0.7	17.6	0.8
1984 Apr.	0.8	0.6	0.9	1.0	0.8	0.7	0.9	0.8	0.6	0.5	1.0	0.6	16.5	0.8
Oct.	0.8	0.5	0.7	0.6	1.4	0.5	0.8	0.7	0.5	0.5	0.6	0.5	7.5	0.6
Average	1.5	0.8	1.0	1.6	0.9	1.0	1.0	1.0	0.8	0.9	1.3	0.9	7.4	1.0

NOTES: 1. For privately initiated buildings containing six or more units. Excluding buildings constructed within six months of the survey dates. 2. Old universe consists of buildings on the market 19 months or longer; new universe seven to 18 months.

SOURCE: CMHC Toronto Branch, *Rental Apartment Vacancy Survey*, various issues; as found in Pringle, 1986, Table 2-21, p. 91.

completed apartments[18] and older buildings.'' (p. 57) Over the period 1973 to 1984 in the Toronto CMA, the average vacancy for such ''new'' buildings was 7.4 per cent; for the ''old'' universe it was 0.9 per cent (Table 6). Even if the vacancy rate is high for ''new'' buildings it does little to increase the overall vacancy rate because new units represent a very small portion of total units. Stanbury and Vertinsky (1986) demonstrate this effect:

> If we take October 1983, when the rate for new buildings was at its highest point (17.6%) while that for ''old'' buildings was 0.7% we find that the ''old'' stock in the CMHC Survey amounted to 270,321 units while the ''new'' stock totalled only 4,655 units. In other words, the high vacancy ''new'' stock represented only 1.7% of the old plus new. The new stock raised the *overall* vacancy rate to 1.0% from 0.7 for the old stock alone (p. 6-91).

In October, 1985, the vacancy rate for the ''old'' stock was 0.3 per cent (275,752 units) 4.6 per cent for the ''new'' (4,817 units). The regular vacancy rate which combines the two was 0.4 per cent. In April, 1986, the vacancy rate for the ''old'' stock was again 0.3 per cent (277,271 units) and 4.2 per cent for the ''new''. However the number of ''new'' units was only 2,890 units. The combined vacancy rate was 0.3 per cent.

3.5 Vacancy Rates by Rent Levels and Unit Type

Since April, 1985, for the Toronto CMA and October 1985, for the Ottawa CMA (Ontario portion) vacancy rates have been available by rent levels or ranges. Tables 7, 8 and 9 show the percentage distribution of vacancies and total units by rent range and unit type (number of bedroom).[19] The data in all tables show that proportionately there are more vacancies in the higher priced units. For example in Table 7, 25.1 per cent of all vacancies in the Toronto CMA, as of the October, 1985, survey, occurred in the $650-749 per month rent range (see Total row). In terms of total units, however, there is a distinct upward bias as only 5.9 per cent of all units have rents in this range. In contrast, while 36.12 per cent of all units had rents in the $350-449 per month rent range, the vacancies occurring in this rent range represented only 7.4 of all vacancies.

Broadening the ranges into $549 or less per month and $550 or more shows the upward bias of rent levels in vacant units more emphatically. Again

18. Until the announced extension of rent regulation to cover all units, the newer buildings were generally uncontrolled. They tend to be higher priced than comparable controlled units.

19. Note that in each table the rent ranges used by CMHC to record the data are different.

TABLE 7: Percentage Distribution of Units and Vacancies by Rent Range and Unit Type

Unit Type	Rent Range (dollars per month) 349 0	449 350	549 450	649 550	749 650	999 750	1000+	Total
Bachelor								
% all units	3.89	2.86	0.75	0.12	0.01	0.03	0.00	7.66
% all vacancies	5.3	1.2	1.6	0.4	0.0	1.9	0.0	10.4
1 bedroom								
% all units	5.53	21.03	9.62	3.39	0.89	0.53	0.23	41.22
% all vacancies	0.9	4.9	3.1	9.8	4.4	1.9	5.2	30.2
2 bedroom								
% all units	0.55	11.86	15.70	7.92	3.18	2.05	0.57	41.93
% all vacancies	0.1	1.3	2.9	7.9	16.4	13.2	7.1	48.9
3 bedroom								
% all units	0.01	0.37	2.59	3.25	1.82	0.74	0.49	9.27
% all vacancies	0.0	1.1	0.2	1.9	4.3	3.0	1.1	11.6
Total								
% all units	9.98	36.12	28.66	14.68	5.90	3.35	1.29	100.0[2]
% all vacancies	6.4	7.4	7.9	19.9	25.1	20.0	13.5	100.0[2]

NOTES: 1. Based on data from regular survey of privately initiated buildings containing six or more units but excluding buildings constructed within six months of the survey date. Nine vacancies which were not recorded by rent range by CMHC are excluded here. 2. Figures do not add to 100% due to rounding.

SOURCE: Derived from CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, October 1985.

in Table 7, while 78.5 per cent (19.9 + ... + 13.5) of all vacancies were in the more expensive $550 or more per month range, only 25.22 per cent (14.68 + ... + 1.29) of all units had rents in that range.[20] Conversely 74.76 per cent of all units had rents of $549 or less per month but only 21.7 per cent of vacancies occurred in this range. Similar results arose within unit-type categories although there were some exceptions. Figure 9 reprinted from the April, 1986, Ottawa survey also shows the upward bias in rent levels among vacancies. The Ottawa CMHC office comments:

> The average rental on two bedroom apartment units is estimated at $529 and about 80% of the vacant units have rentals above this level.

20. Figures do not add to 100 per cent due to rounding.

TABLE 8: Percentage Distribution of Units and Vacancies by Rent Range and Unit Type, Toronto CMA, April 1985[1]

Unit Type	Rent Range (dollars per month) 349 0	449 350	549 450	649 550	749 650	750+	Total
Bachelor							
% all units	4.72	2.61	0.59	0.06	0.04	0.03	8.05
% all vacancies	2.5	3.7	5.3	0.5	0.5	0.4	12.9
1 bedroom							
% all units	7.29	22.02	7.83	2.64	0.76	0.34	40.88
% all vacancies	1.29	8.38	4.11	8.38	3.43	3.12	28.2
2 bedroom							
% all units	0.95	15.08	14.85	6.84	2.32	1.79	41.83
% all vacancies	0.1	1.7	4.7	8.2	17.4	15.1	47.1
3 bedroom							
% all units	0.01	0.64	3.58	2.75	1.24	1.03	9.25
% all vacancies	0.0	0.2	1.7	1.2	4.3	4.0	11.4
Total							
% all units	12.97	40.35	26.85	12.29	4.36	3.19	100.0[2]
% all vacancies	3.9	13.9	15.7	18.3	25.7	22.5	100.0[2]

NOTES: 1. Based on data from regular survey of privately initiated buildings containing six or more units but excluding buildings constructed within six months of the survey date. Sixty-six vacancies which were not recorded by rent range by CMHC are excluded here. 2. Figures do not add to 100% due to rounding.

SOURCE: Derived from CMHC, Toronto Branch, *Rental Apartment Vacancy Survey*, April 1985.

The gap is less extreme within one bedroom units since only about 60% have rentals above $424, the average rental for one bedroom units.

In Toronto, across unit type categories (see Total column, Tables 7, 8) more vacancies occurred in two bedroom units than in one bedroom units although they had almost identical percentages of all units. In Ottawa (Table 9), two bedroom units had more vacancies than one bedroom units although the latter outweighed the former in terms of the proportion of the market

3.6 Vacancy Rates in Small Buildings

In April 1985, the Ottawa branch of CMHC conducted a special vacancy survey of small buildings (privately initiated) containing less than six units in the Ontario portion of the Ottawa CMA (which includes Hull, Quebec). Approx-

TABLE 9: Percentage Distribution of Units and Vacancies by Rent Range and Unit Type, Ottawa CMA (Ontario portion), October 1985[1]

	Rent Range (dollars per month)					
Unit Type	299 0	374 300	449 375	549 450	550+	Total
Bachelor						
% all units	2.04	4.31	1.95	0.04	0.06	8.40
% all vacancies	1.7	3.5	2.3	0.0	0.3	7.8
1 bedroom						
% all units	1.07	13.03	19.32	14.00	1.12	48.53
% all vacancies	0.3	11.3	13.3	8.1	3.2	36.1
2 bedroom						
% all units	0.10	2.05	9.10	14.84	12.96	39.04
% all vacancies	0.0	0.6	1.7	8.4	37.6	48.3
3 bedroom						
% all units	0.00	0.02	0.20	1.25	2.56	4.03
% all vacancies	0.0	0.0	0.3	1.2	6.4	7.8
Total						
% all units	3.21	19.41	30.57	30.13	16.69	100.0[2]
% all vacancies	2.0	15.3	17.6	17.6	47.4	100.0[2]

NOTES: 1. Based on data from regular survey of privately initiated buildings containing six or more units but excluding buildings constructed within six months of the survey date. Four vacancies which were not recorded by rent range by CMHC are excluded here. 2. Figures do not add to 100% due to rounding.

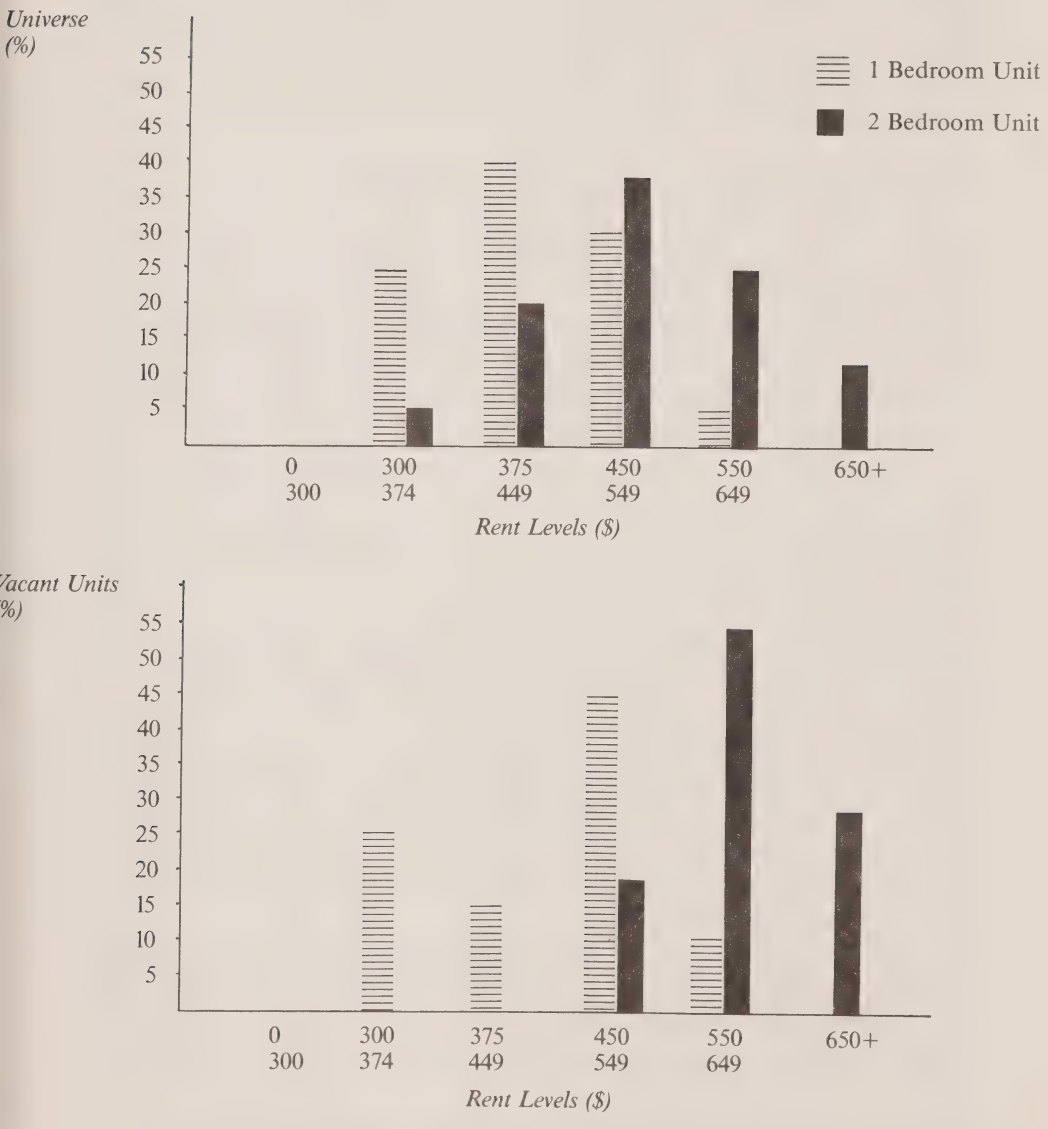
SOURCE: Derived from CMHC, Ottawa Branch, *Rental Apartment and Row Housing Vacancy Survey*, October 1985.

imately 20 per cent of buildings containing three, four and five units were surveyed. The vacancy rate was 1.0 per cent in these buildings. Buildings containing six or more units (the regular CMHC survey) had a vacancy rate of 0.9 per cent. CMHC concludes that there was no significant difference between the two surveys[21] — in other words the results of the regular survey of buildings containing six or more units may be representative of vacancies in all buildings (privately initiated) in Ottawa. On the other hand Mascall's (1985) survey estimated that buildings with five or fewer units had fewer units vacant and immediately available than in larger buildings.[22]

21. CMHC, Ottawa Office, *Rental Apartment and Row Housing Vacancy Survey*, April 1986, Appendix II.

22. They suggest the slight difference may be due to sampling irregularities.

Figure 9: **Percent Distribution of Units Within Rent Ranges; Comparison of Distribution[1] of Vacant Units[2] With Total Units by Unit Type Ottawa CMA, April 1986.**



NOTES: 1. Vacancy percentages by unit type do not add to 100 due to the exclusion of a small number of units where vacancies were not recorded by rent levels.
2. Vacant units are those in privately initiated buildings containing 6 or more units. Excludes units in buildings completed within 6 months of the survey date.

SOURCE: Adapted from CMHC, Ottawa Office, *Rental Apartment and Row Housing Vacancy Survey,* Figure 1 April 1986.

3.7 Vacancy Rates in Publicly Initiated Buildings

Vacancy rates in publicly initiated buildings are available from CMHC, generally, in aggregated data at CMA levels. Because of extensive waiting lists for socially assisted housing and since the total of socially assisted units is small (about 13 per cent as of 1981) relative to the entire stock of rental housing,[23] vacancy rates for both publicly and privately initiated buildings (Table 10) are not appreciably different from those in the privately initiated buildings only (see Table 1).[24]

4. The CMHC Survey: Sample Representativeness

Various measures of availability according to the CMHC vacancy survey were presented in section 2. The most common as emphasized in the data presented in this Appendix is the "regular" survey universe of privately initiated units in buildings containing six or more units and on the market for more than seven months. Those survey results may not be representative of the availability of accommodation in the overall rental market.

Pringle (1986) compares the number of units surveyed by CMHC with Census estimates of rental housing stock. He found for the province's CMAs that representation tended to vary with city size ranging from 28 per cent in Thunder Bay to 59 per cent in Toronto." (p. 191). An unweighted average for the 10 CMAs was 45 per cent. Pringle observes that other things being equal "these figures suggest the survey is a more accurate indicator of overall market conditions in the larger cities." (p. 191) MMAH (1983) indicates that about 34 per cent of units in the 10 CMAs were in buildings containing five or fewer units (Table 5). With the majority of the remaining units outside these CMAs (i.e. in smaller urban and rural centres) likely to be in small buildings, say 75 to 80 per cent, conservatively, it is not unreasonable to suggest that about 45 per cent of all rental units in Ontario are in smaller buildings containing less than six units. Thus close to one-half of all rental units in the province are not surveyed by CMHC.

In section 3.6 it was noted that a special survey of small unit buildings by CMHC concluded that there were no significant differences between the regular survey and vacancies in small buildings not included in that survey. In other words, for Ottawa, the CMHC survey was fairly representative of

23. Section 4 discusses the representativeness of vacancy rates as measured by CMHC relative to the availability of units in the entire rental market.

24. The share of net additions to the rental stock comprised of socially assisted units has increased recently. See Muller (1986, pp. 37-43).

TABLE 10: Vacancy Rates[1] in Selected Metropolitan Areas, Publicly and Privately Initiated, 1965-1985 (Percent)

Area	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Ontario																					
Hamilton	1.3	1.4	1.4	1.9	1.3	2.1	2.0	2.0	2.2	1.8	2.4	3.0	4.0	3.7	2.7	1.7	1.2	0.7	1.1	0.8	0.5
Kitchener	—	—	—	—	—	5.3	6.0	3.2	4.4	4.8	2.6	3.0	2.8	2.7	2.2	1.6	1.2	0.9	1.5	0.6	0.4
London	—	—	—	—	3.9	5.0	4.3	5.7	6.0	4.0	2.5	2.1	1.7	2.0	3.8	4.5	2.6	2.5	2.8	1.6	0.7
Oshawa	—	—	—	—	—	—	—	—	—	—	—	—	1.4	1.5	2.7	2.4	0.5	0.3	1.2	0.8	0.1
Ottawa	8.7	7.3	1.9	1.4	1.4	1.7	1.8	1.8	2.0	3.0	2.0	1.9	1.5	1.2	2.7	3.4	1.3	0.3	0.2	0.3	0.8
St. Catharines-Niagara	—	—	—	—	—	—	—	3.1	3.9	4.4	2.9	2.0	1.5	1.7	2.1	2.3	1.2	1.3	1.8	0.9	0.5
Sudbury	—	—	—	—	—	0.3	0.3	5.1	10.3	6.8	1.8	1.0	1.0	4.6	7.7	2.6	1.1	1.0	1.0	0.7	0.7
Thunder Bay	—	—	—	—	—	—	—	0.7	1.2	1.1	0.5	0.3	0.2	0.9	1.1	0.9	1.1	0.8	0.7	0.7	0.4
Toronto	1.5	0.9	1.1	1.4	2.3	2.5	3.0	2.6	1.6	0.9	1.3	1.1	1.0	0.8	1.1	0.9	0.4	0.5	1.0	0.7	0.5
Windsor	—	—	1.0	1.5	0.6	1.3	1.8	2.0	2.3	2.7	3.5	2.6	1.3	0.8	1.4	4.3	7.6	4.8	2.1	1.0	0.7
West																					
Calgary	7.8	7.2	1.4	1.1	1.8	6.5	8.6	7.8	8.3	3.6	1.2	0.3	0.3	1.2	1.3	0.9	0.5	3.8	11.4	11.8	5.7
Edmonton	6.5	2.3	2.3	2.3	3.0	3.8	5.7	6.8	6.7	3.1	0.6	0.1	0.2	0.9	2.5	1.9	1.8	1.8	8.3	10.5	6.4
Regina	—	—	—	—	3.8	10.7	6.5	2.1	1.3	0.4	0.1	0.3	0.8	2.2	2.7	1.4	1.2	0.6	2.2	2.2	3.1
Saskatoon	—	—	—	—	10.1	20.3	16.4	4.6	3.4	1.0	0.1	0.1	0.2	0.9	2.1	1.2	1.2	1.5	2.6	2.8	2.8
Vancouver	4.0	1.3	1.0	1.3	1.0	2.3	3.3	1.4	0.6	0.2	0.2	0.5	1.6	1.4	0.6	0.1	0.1	1.1	1.8	2.1	2.4
Victoria	—	—	—	—	3.2	5.2	4.1	1.9	0.9	0.3	0.2	0.4	2.7	2.8	0.9	0.1	0.1	1.0	1.9	2.8	2.4
Winnipeg	4.9	4.1	1.5	1.5	1.6	2.9	4.5	4.7	3.6	2.1	1.7	1.4	1.5	2.6	4.4	4.5	3.6	1.6	1.1	0.9	0.9
East																					
Chicoutini-Jonquiere	—	—	—	—	—	—	—	2.9	2.0	3.0	1.3	0.8	0.5	0.6	1.8	1.6	0.8	2.7	2.4	1.5	2.0
Halifax	3.9	3.4	2.5	0.4	0.5	2.6	3.7	3.0	2.3	2.5	2.4	2.2	2.2	2.4	2.8	1.9	0.8	0.7	1.4	0.6	0.7
Hull	9.0	3.5	0.8	0.5	0.9	2.1	3.0	3.6	2.4	2.0	3.7	7.2	8.1	8.1	7.6	7.3	4.2	1.3	0.6	0.7	2.8
Montreal	5.9	4.4	1.2	4.7	6.4	7.1	5.7	4.3	3.0	1.9	0.9	1.0	2.5	4.5	4.5	3.6	2.0	2.1	2.9	2.5	1.8
Quebec	6.4	5.1	2.2	2.2	2.8	2.8	4.6	6.3	4.3	3.0	1.3	0.9	1.4	2.6	3.5	2.6	1.7	2.9	4.0	2.2	1.3
Saint John	—	—	—	—	0.4	1.5	0.7	0.8	0.7	1.5	0.4	5.4	11.2	11.0	7.3	3.7	3.4	3.1	3.3	3.8	3.2
St. John's	—	—	—	—	17.2	20.7	3.6	0.5	0.3	0.4	1.7	2.1	3.0	7.3	3.3	1.3	1.0	3.5	3.8	2.7	2.3

NOTE: 1. In buildings containing six or more units. Excludes buildings completed within six months of the survey dates. Data for 1965 to 1968 are for June; thereafter the estimates are averages of the twice yearly surveys.

vacancies in all privately initiated buildings. Abt Associates (1980)[25] discusses the results of estimates of vacancies in small buildings in East York in the Toronto CMA. For small buildings a 0.9 per cent vacancy rate existed; for buildings with six or more units the vacancy rate was 0.6. The difference according to the authors was not statistically significant. Those results would seem to support the findings of the CMHC Ottawa office.

In the Mascall (1985) survey small unit buildings (less than six units) comprised 36 per cent of the sample but represented 58 per cent of immediately available units. Larger buildings (six or more units), on the other hand, had fewer vacancies (about 45 per cent). The overall vacancy rate, however, did not change appreciably because of the relative market proportions of the two building size categories.[26]

In section 3.5 it was shown that vacancies for the Toronto and Ottawa CMAs, as measured in the CMHC survey, are not distributed among units according to the distribution of units by type or rent range. Rather, more vacancies occur in higher priced units. Hence the CMHC vacancy rate may tend to over estimate the availability of units particularly for those households seeking units with lower rents.

A final consideration relates to the definition of availability as measured in the CMHC survey. That survey counts only those units unoccupied and available for rent as of the survey date. Stanbury and Vertinsky (1986) note that while vacancy rates have declined, tenant mobility rates appear high relative to vacancy rates. The number of units which turn over has declined much less than the vacancy rate. They suggest there is a "large-scale informal market in tenancies that does not show up in CMHC's vacancy survey or in the newspaper ads." (p. 6-136)[27] Turnovers occur without vacancies arising. Mascall (1985) observes that units about to be vacated are often already rented by new tenants as a result of various information exchanges. Thus the units are never empty and available to be counted in a CMHC survey. Also structural changes in landlord and tenant law may contribute to a reduction in vacancy rates. For example, there is now more lead time when there is about to be a change in occupancy than there was 15 year ago. As a result it is more likely the unit will be rented before the incumbent tenant leaves. Mascall's survey covered all rental units regardless of building size and type. As well the survey

25. As cited in Pringle (1986, p. 191).

26. As discussed at the end of this section, significant differences were apparent between the relative tightness of the rental housing markets as measured by CMHC and as measured by Mascall (1985).

27. See Pringle (1986, pp. 192-193) for a discussion of rental vacancies as advertised in the classified newspaper ads. Pringle also discusses the strengths and weaknesses of the CMHC survey (pp. 190-196).

covered "units which were available either immediately or at a specified future date which in practice was not more than six weeks distant." (p. 91) His survey estimated that the CMHC survey accounts for only about one-half the available units that are advertised.[28] Given the CMHC vacancy rate of 0.6 per cent units in buildings with more than five units, the available rental housing units in the entire market was estimated at about 1.3 per cent.

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28. As well, a considerable number of single family homes and condominiums are rented. See Pringle (1986, pp. 67-73).

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Appendix G

Maintenance and Conservation of the Rental Housing Stock in Ontario

Introduction

This Appendix examines the evidence concerning maintenance and conservation of Ontario's rental housing stock. It begins by discussing the distinction between maintenance and conservation. The empirical work related to, and perceptions of changes in, the levels of maintenance and conservation are then reviewed.

1. Definitional Considerations

It is useful to distinguish between maintenance and conservation of housing. This is done in a study of rental housing prepared for the Ontario Ministry of Municipal Affairs and Housing and the Association of Municipalities of Ontario in 1982 by a consortium of consultants which included architects, engineers and economists. The study was under the direction of Klein and Sears Research and Planning Ltd. (Klein and Sears). In Volume I of their 1983 report they state:

> While the terms ''maintenance'' and ''conservation'' as they relate to buildings are sometimes used interchangeable with regard to certain issues, in fact, these terms have quite different and distinct meanings. These meanings and some illustrations of the areas of overlap follow:
>
> All buildings require *maintenance* to retain them in a stable condition whereby they can be used daily. A building simply cannot be left without attention to a myriad of individual items. These include many so called cosmetic treatments such as cleaning, decorating, and cut-

> ting grass, that are necessary to preserve the surface quality or appearance of a building. In addition to cosmetic maintenance needs, all buildings require regular upkeep or maintenance to parts of the building fabric and equipment. Such maintenance can involve regular service and minor repairs to the heating system, the elevators, safety systems, and to less apparent items like caulking and attention to roof flashings. These are all activities necessary to counter the effects of age and use on the building. Every building, large or small requires such attention.
>
> The process of *conservation*, while inextricably related to maintenance, has a different meaning and thrust. Conservation implies preservation over an identified period of time, such that the building can be safely used and enjoyed over its expected life span. This implies that measures must be taken to prevent the premature decay or loss of the building or its parts. As with maintenance, all buildings require conservation measures to prevent their premature loss through neglect or initial faulty design or workmanship. By way of explanation, a dirty wall may be unsightly but will not directly contribute to decay. The dirty wall is a maintenance item. A leaking roof may also create unsightly conditions but will most probably contribute to the accelerated decay of the very fabric of the building. A leaky roof will be a conservation as well as a maintenance item. The process of conservation in buildings is further regarded as including the activities which may be carried out to upgrade parts of the building to meet the standards of by-laws and codes which may not have existed when the building was constructed; or to introduce elements in the building which would reflect current operation objectives such as insulation or double glazing to reduce energy consumption. In some discussions, conservation is referred to as preventative maintenance. (p. 66)

A third significant type of expenditure is for capital improvements which include such items as the installation of a swimming pool, a fire alarm system or electronic security equipment. Desirable as some of these improvements may be, they are neither recurring nor unavoidable expenditures. The impact of capital improvements on the landlord's financial and rental policies is not reviewed in Klein and Sears or in this Appendix.

Klein and Sears point out that because the effects of sustained inadequate maintenance and conservation can lead eventually to expenditures which might not otherwise have been necessary, most landlords would maintain their prem-

ises at least up to the standards related to the quality and marketing image of the building. This is most likely to occur in a competitive environment.

Stanbury and Vertinsky (1986) disagree with the preceding definition of conservation.[1] In their view conservation expenditures should lengthen the service life of a building. They say (p. 6-67):

> Their [Klein and Sears] definition of conservation expenditures is wooly (sic). One re-reads it again and again for any indication that such expenditures — over and above normal maintenance — will in fact *extend* the economic life of high rise buildings. Indeed, theirs is an engineering approach to preserving the high-rise rental stock at some level of quality throughout its life. Both the lifespan and the level of quality are not explicitly defined. [Emphasis in original.]

Whether conservation is viewed as those activities which are necessary for a building to remain liveable for a preconceived period of time or alternatively as a way to extend the life of a building relative to its expected life if conservation activities are not carried out, conservation differs from maintenance in two important ways. First, conservation tends to involve larger but more irregular expenditures than maintenance. Second, many conservation activities can be more easily deferred without immediate cosmetic deterioration of the premises, but delayed conservation can greatly increase the eventual cost of conserving the building. It is apparent that the difference is one of degree more than the nature of the expenditure; hence, applying this label may be difficult in certain cases.

2. Changes in the Level of Maintenance

Efforts have been made to determine by empirical surveys whether the condition of the rental housing stock has deteriorated over the decade of rent regulation and, if so, to what extent regulation has been the cause. Because no study of the state of maintenance and conservation of rental housing was made before regulation was imposed in 1975, post-regulation surveys, even if they provide a reasonably valid report on the state of affairs existing at the time of the survey, do not have a comparable, pre-regulatory standard.

In 1975, the Ministry of Housing (it became the Ministry of Municipal Affairs and Housing in July 1981 and is now, once again, the Ministry of Housing) initiated what became an annual rental market survey of seven Ontario cities. The series concluded with the survey for the year 1981. Among the

1. On the definition of maintenance and conservation see, also, the testimony of J. Klein, Tr. 129-2, pp. 5-11 and W. Stanbury, Tr. 96, pp. 3-16.

matters surveyed were tenants' perceptions on matters of interest to the Ministry. Each year some 5,000 telephone interviews were conducted on a random basis with tenants living in both controlled and uncontrolled rental housing but not including publicly-assisted housing. The tenants were asked for their general opinions on the quality of maintenance and services.

The condition of their units was not distinguished from the overall maintenance of the building in which they lived.

In October, 1981, five years after the commencement of rent regulation, only 15.3 per cent of those interviewed in Metro Toronto reported the level of maintenance and services to be poor or very poor.[2] In other cities the average per cent of those interviewed who had the same opinion was less than 10 per cent. Only 11 per cent or less reported that the level of services and maintenance was worse than cent or less reported that the level of services and maintenance was worse than in the previous years. The Ministry had not asked this question in its earlier survey. This data was referred to as "soft".

The form of these surveys, the absence of any reports from landlords or independent on-site observers, the lack of an objective base regarding the condition of the properties when the surveys began and the fact that no distinction between controlled and uncontrolled units was made, militate against engaging in an exhaustive analysis of the data. The consistently modest fraction of the tenants who reported poor levels of maintenance and services and the steady level of opinion that there was little change from one year to the next in standards of maintenance and services do not support a finding that rent regulation had an apparent adverse effect at least up to 1981. However, it may be the case that a decrease in maintenance expenditures, rather than showing up immediately, has a cumulative impact in terms of the seriousness of problems. When problems become visible the deterioration may have reached the point where a major capital expenditure is necessary, although it may have been avoidable by following regular maintenance procedures.[3]

In July, 1982, the Ministry published a staff research report entitled *The Impact of Rent Review on Rental Housing in Ontario* containing analyses under relevant heads of data obtained from surveys conducted in April, May and June of 1981 by an independent survey organization. The surveys were limited to buildings of 20 units or more in Metro Toronto. A survey of the landlords of 307 buildings was conducted by personal interviews. The buildings ranged in size from 20 to 200 or more units and 300 of them were built prior to 1976 and hence were under rent control. The tenants of 225 of these buildings were

2. Ontario, MMAH (1982a), Table 3.5, p. 47.

3. See the testimony of J. Bassel, Tr. 97-2, pp. 143 and 163-165, J. Gould, Tr. 140, pp. 3-14 and M. Lavine, Tr. 127-2, pp. 109-116.

interviewed by mail. A site survey was conducted on all buildings for which landlord interviews were obtained.

These surveys were much more intensive and hence the data are more reliable than in the case of the annual surveys limited to tenant perceptions which had been conducted since 1976. However, given the importance of the maintenance issue with respect to rent regulation, it is rather surprising that although uncontrolled buildings also were surveyed and the landlords and tenants pertaining to them were interviewed, the data obtained were not segregated from and compared with data relating to controlled buildings.

The research report states that the primary focus of the study on current levels of maintenance was an attempt to answer the question of whether maintenance levels were adequate after five to six years of rent review. The secondary focus on changes to maintenance looked at the question of whether maintenance levels had changed during the rent review period.

The data accumulated from the 1981 surveys were analyzed and correlated. The study concluded that in general, "tenants, landlords and site visitors have confirmed that, in terms of results, maintenance levels in Ontario are good or very good and landlords and tenants agree that little change is occuring in these levels." (MMAH, 1982b, p. 6)

Comments by Stanbury and Vertinsky (1986) on the staff research report are of particular interest. They say:

> . . . despite five years of rent controls at least twice as many landlords state maintenance has improved as say it has worsened over the past five years. These results are not consistent with the widely-made assertion that rent controls inevitably result in reduced maintenance by landlords.
>
> Landlords were asked in the 1981 survey "Are there any obstacles which prevent you from maintaining this building at the quality level you would like to obtain?" Thirty-two percent said there were no obstacles (MMAH, 1982, p. 59). Rent review was mentioned as an obstacle by 24% of landlords and 49% said "lack of funds" was an obstacle. What these data seem to indicate is that despite rent review and a lack of funds as obstacles to maintaining their buildings to the quality level they desire, landlords have, in their own perception, been able to improve maintenance under controls more frequently than they have allowed maintenance standards to decline. Tenants and independent site visitors are less sanguine about the present level of maintenance associated with their buildings than are landlords. However, on balance, tenants believe — on a year-by-year basis —

> that more frequently maintenance has improved than has gotten worse. (pp. 6-60–6-61)

The most recent investigation of the effect of rent regulation on maintenance is a telephone survey conducted in December, 1985, for the The Fair Rental Policy Organization of Ontario. Included among the members of this organization are most of the major land developers, builders and owners. Entitled a *Rent To Income Study*, this February, 1986, report's introductory comment states that "The primary object of the study was to determine the percentage of total household income paid in rent" and describes the methodology of the survey as follows:

> At the outset, we considered limiting eligibility for study participation to renters in units currently under rent control. However, in view of changes made in rent review and awards made by the Residential Tenancy Commission, we did not feel individuals would know with absolute certainty whether or not the unit in which they lived was subject to rent control. A screening procedure based on this criterion was therefore not viewed as meaningful, and for this reason, we used a stratified random sample of four hundred renters in Metropolitan Toronto. A sample of this size is accurate within four percentage points, nine times out of ten. Because of the random manner in which the sample was selected, it is reasonable to assume that eighty percent of our survey respondents live in rent controlled units, in keeping with the eighty percent of the units that are actually under rent control in Ontario. (p. 2)

The questions put to the respondents to the survey however, went beyond interest in their rent payments and asked, among others, the following:

> How would you rate the current level and quality of maintenance in your building?
>
> Has the standard of maintenance over the past ten years improved, stayed the same, or declined?

The editorial comment in the study on the answers to the question with regard to the quality of maintenance is:

> . . . a clear majority (64 per cent) felt that their units were either well or adequately maintained. This contrasted with 19 per cent who felt that their apartments were fairly well maintained, and only 17

> per cent who felt their rental accommodation was not very well maintained or not at all well maintained. On the surface, this would appear to indicate that apartments in Metro Toronto are well maintained. (p. 4)

With regard to the second of the above questions the editorial comment is:

> Almost two-thirds of the respondents (63 per cent) felt that the quality of maintenance had stayed approximately the same over the ten year period. The remaining respondents were roughly split, with a slight plurality feeling that the quality of maintenance had improved (19 per cent) while the remainder (15 per cent) felt the quality of maintenance had declined. (p. 5)

3. Changes in the Level of Conservation

A distinction between maintenance and conservation, latent in the definitions given in the Klein and Sears (1983) report, is that while deficiencies in maintenance have direct and relatively immediate consequences for tenants, an inadequate conservation policy — although it will not affect tenants as directly — has serious long-term consequences. An old and deteriorated roof, if not attended to, will result in leaks. These in time will create unsightly conditions and inconvenience tenants but also will most probably contribute to the accelerated decay of the very fabric of the building. Not only will this decrease the value of the property but could lead to the building becoming uninhabitable or if not that extreme result, to large repair costs, much greater than would have been incurred if conservation action had been taken at the proper time. These costs will fall on future tenants or will have to be met at the public expense in some other way.[4] The consequences of not incurring conservation costs can go much beyond those usually arising from cutting maintenance costs.[5]

There have been two relatively recent surveys of the structural condition and conservation of rental apartment buildings and active participants in the survey operations gave evidence before the Inquiry. The first survey was the 1983 Klein and Sears study which was concerned with high-rise rental apart-

4. If landlords cannot recover the cost in rents or subsidies, there will be a strong incentive to allow the building to decline to the point at which demolition and redevelopment will be approved.

5. See the testimony of the witnesses noted in fn. 3 above.

ments. The investigation was carried on in 1982 in municipalities throughout Ontario. Klein and Sears did not define what is meant by a high-rise apartment but for the purposes of analysis used as a model a hypothetical building 13 to 20 years of age with 120 suites, made of reinforced concrete, eight to 12 stories high and with underground parking. Jack Klein, an architect, said one of the study's objectives was to examine issues relating to the conservation of Ontario's existing rental housing stock — particularly the high-rise central housing stock — and what had to be done to ensure that it stayed in its present configuration. (Transcript Volume 129-2 p.4) Neither in the Klein and Sears report nor in the witness's evidence are there statements to the effect that the state of high-rise rental structures is a matter of immediate concern. It is said, however:

> The rent review process has had an effect on the attitude which building owners take to conservation. The indication we have received from discussions with building owners is that major conservation/preventative maintenance activities are being delayed or that conservation actions are being replaced by repair and patching actions. In the long-term over the next 20 years, this will have a marked negative effect on the quality of the high-rise rental housing stock. (Vol. 1, p. 71).

With that prospect in mind, the Klein and Sears study sought to estimate what it would cost to conserve the existing stock of high-rise rental apartments over the next 20 years. Five "case study" buildings were examined. The estimates ranged from $4,460 to $13,900 per suite, for two public sector building, 18 and 24 years of age respectively and from $6,800 to $10,200 per suite for two private sector buildings nine and 11 years of age respectively. In no instance was the total cost estimated to be less than $1-million. The study went on to estimate the rent increases which would have to be obtained to meet these costs assuming the present rent review process remained unchanged. In his oral evidence, Klein said:

> Indeed, notwithstanding the large costs that are represented in conservation, it is our view that they represent only approximately one-quarter of the replacement cost of the dwelling units, if, indeed, the units were permitted to prematurely die . . . and had to be replaced. The tenants are out there, they need places to live. And if, through neglect, the buildings were permitted to deteriorate to the point where they couldn't be occupied and [it] became necessary to provide new accommodations, it will cost at least four times more to provide new

> accommodations than it would to conserve the assets at this time. (Tr. 129-2, p. 55)

The second study (Peter Barnard Associates, 1985), funded by the MMAH in 1984, was concerned with the low-rise rental stock. For the purpose of this study a low-rise apartment building was defined as a building with a minimum of three rental units and a maximum of four stories. In the course of the study a random sampling of 102 low-rise buildings located variously in Hamilton, Ottawa and Toronto were physically inspected. The buildings were commonly solid brick, had an average age of 37 years and 82 per cent had flat roofs. The inspections were conducted in seven study areas viz construction type, condition of the components, condition of the structure, fire safety, energy, efficiency, mechanical and electrical equipment and a general overview.[6] The ratings assigned under these categories were combined into a single measure of building condition and rated very poor, poor, fair, good, very good and excellent. Twenty-four per cent of the buildings were rated poor or very poor, 59 per cent were rated good or better.

Expert consultants who participated in the study were asked for their opinions regarding the effect of rent regulation on the condition of the buildings, the landlords' intentions regarding their properties and the prospect for loss of some part of the stock. Relevant excerpts from their reports and their oral evidence follow. Frank L. Graves, project manager of a study conducted by Ekos Research Associates Inc. (Ekos, 1985), entitled *The Coming Crisis: Low-Rise Rental Housing in Metropolitan Toronto*, said in his oral evidence:

> I think, unquestionably, there will be a serious net reduction in the supply of affordable low-rise rental stock as a result of those trends [restrictions on income of landlords].
>
> . . . by leaving the current status quo [of rent regulation] in place, we are putting in abeyance the problem of dealing with the fact that we're having an erosion in the supply of this stock which will possibly increase the problem; that is, the attenuation of the stock at an even greater rate in the near future.
>
> In immediate terms, it perhaps doesn't look as [if] it's as urgent a problem as it does when you cast it in a ten-year, fifteen-year framework.
>
> . . . there will be an enormous liability, public liability, because the stock is disappearing most rapidly at the bottom end, in those very places which are occupied by those people in the most severe

6. As described in the testimony of K. Coulter, Tr. 131-2, pp. 10-13.

> affordability problems. These are the places in the most dire physical condition.
>
> I am quite convinced that, unchecked, this will be the most significant housing problem in the country by the year 2000; maybe even the most severe public sector problem in Ontario at that time. (Tr. 128-2, pp. 108-110)

Michael Rowland of Peter Barnard Associates, who prepared the earlier cited report, told the Inquiry:

> . . . while rent control has served, I feel, the interests of a portion of the tenants in this stock [low-rise housing], perhaps it has not served the interests of others in that it has had effect on the physical quality of the buildings because landlords have not done the repair that the buildings require either because they don't have the money to do it, or because they don't feel the cost of that repair will be . . . given back to them if they go to rent review. So there has been some disbenefit to those tenants in that way.
>
> The other conclusions that I would draw in terms of the impact of rent review on tenants is that in the long run these changes of physical deterioration, and possible physical loss, and market changes, the changes in the market role, have in part been generated as a result of a rent review system in Ontario, and that while in the short time tenants with low income have benefitted from the existence of a rent review system in this stock, in the long run if the stock is lost, and if the loss of that stock is accelerated, as we expect it will be through physical deterioration, and through all these market changes, in the long run that does not serve the interests of tenants, or the (landlords) because they may lose their buildings. (Tr. 130-2, pp. 75-76)

The various surveys appear to show little evidence of a decline in standards. As described above, however, many have serious methodological flaws. Moreover, expert witnesses argue that there is a cumulative effect in terms of the serious consequences of not undertaking normal maintenance and repairs. This results in considerably more expensive repairs.

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Appendix H

A Review of Submissions to the Inquiry

Introduction

This Appendix provides a review of the issues as recorded in briefs submitted to the Inquiry. The focus is on those briefs discussing concerns and issues of Phase II of the Inquiry's Report. Briefs containing a confirmation of intent to appear at the hearings and an an outline of issues to be addressed are not reviewed. The views of those persons and groups are cited in the Report and contained in the transcripts of the Inquiry's hearings.

This Appendix loosely follows the effects and consequences of rent regulation as outlined in Chapter 1 of the Report: return on investment/profitability; affordability; effects on the existing housing stock; effects on new supply; and distributive issues.

1. Role of a Competitive Rate of Return

A small number of briefs stress the importance of landlords or investors earning a competitive return to ensure the well-being of the rental market. S. Bhardwaj comments:

> Everybody realizes that shelter is an essential service and that the only long term solution is in creating an equilibrium between supply and demand. We also know that to bring about an adequate supply of anything, it is important for the government to recognize the prospect of a reasonable return to the investor. We must also keep in mind that besides the reasonable return for his investment, the investor takes a tremendous risk in a venture of this kind. Conse-

> quently in arriving at the figure of a reasonable return, this risk factor must be clearly recognized and considered. (Brief 8, p. 1)

One landlord group comments:

> It should also be considered that any owner of multiple-residential housing is providing an *essential service* to the community as well as conducting a business. In order to do this properly he/she must be allowed to earn a fair and just investment return. (Brief II-4, emphasis in original)

In the opinion of another:

> For reasons which are largely political and perhaps social, a government may find it desirable to impose rent controls. That does not mean that they will be efficiently imposed nor equitably applied. If such an interference in the market is chosen, such controls must embody a "fair return" to investors in rental property, otherwise there will eventually be no property to rent. (Brief 26, p. 4)

Another landlord group says:

> Many of our members are working people who have put their entire savings into property in order to make a living in their retirement age and all they see is a constant erosion of what they have bought and paid for. (Brief 2, p. 1)

For some the solution to deteriorating profitability is to divest themselves of their holdings:

> The existence of rent review in Ontario has itself already depressed landlord return on investment. For many, the only real payoff comes when they sell their buildings. If their opportunity to recoup si sharply reduced or eliminated, there is little incentive for any private sector investment in the rental market. (Brief 72, p. 2)

Another comments that rent regulation has:

> . . . depressed values of apartment buildings considerably and created a situation where there is little or no demand to purchase apartment buildings unless they are sold at "bargain" prices. (Brief 98, p. 3)

Tenant groups acknowledge landlords' need to realize an adequate return on investment but also express their own concerns about how this return is to be realized. The representative of one group comments:

> . . . I firmly believe any rent review legislation should provide a reasonable rate of return for the landlord. Without some assurance of a profit the subject of rent review becomes academic. No one will build or maintain rental accommodation without such assurance. (Brief 83, p. 1)

He continues:

> The crux of the matter as I see it is: what constitutes a reasonable rate of return on an investment? All forms of investment involve some degree of risk. Where a very high risk is likely in a short term investment the rate of return must be high to compensate for the risk. Where longterm, low downside risk investments are concerned a low rate of return is normally expected.
>
> Real estate in any form is traditionally a longterm, low risk investment. Indeed, it is difficult to lose money if a property is in a promising location and it is held as a long term investment. By merely waiting until the market goes through its periodic speculative cycles, and selling at the right time, a very handsome profit is almost guaranteed. This is sound business practice. (Brief 83, p. 1)

Another group comments:

> The majority of tenants are prepared to pay an ecomomic rent, that is an adequate sum to recover actual costs of operation, upkeep and the recovery of the investment in current value terms. It is recognized that escalating interest costs, utility charges and taxes have to be passed to tenants, but based on verifiable facts. The majority of landlords have in fact been fair and equitable in dealing with these matters, but most concern has arisen due to change of ownership. A sale price based on the new owners' ability to raise rents significantly due to carrying costs is in fact capitalization of the tenants inability to move to alternative accommodation and in our view is a form of exploitation of individuals who in many cases do not have the knowledge or organization to defend their interests. (Brief 49, p. 1)[1]

For others, there is a particular concern over what is considered by some individuals to be speculation in rental housing by some property owners. For example, one brief comments:

> 'Landlord' is a sobriquet which the unscrupulous speculator has in practice not earned, and does not in fact deserve. Speculators buy and sell with scant regard for their tenants, taking advantage of laws which practically beg them to fleece those who rent their apartments. They reap exorbitant capital gains which are, to the very last penny, paid for by tenants. And because the vacancy rate in Metro Toronto is nil, leaving tenants nowhere else to turn for affordable accommodation, tenants are squeezed without let. (Brief 21, p. 3 of petition)

A few tenants raised concerns over the long-run implications for their own well-being because of the low returns being offered their own landlords. A. McLeod says:

> I *do* believe in rent controls. It would just be a catastrophe for thousands of families and individuals during this recession if the government had not instituted the rental control program when it did and maintained it thus far!
>
> However, each year, when I receive notice from my landlord of the 6% rent increase for the next year, I do feel that it is unfair to *my* landlord that he should not be more rewarded for the quality of care that he provides to his tenants and to his building and property. I am now paying only $322.23 a month for a large, well finished one bedroom apartment in a building surrounded by a beautifully landscaped site. And I have been told that the vacancy rate in Toronto now is 0.3%. This is not right! (Brief 6, p. 1, emphasis in original)

Another tenant acknowledges the low rate of return afforded his landlord and the long-run threat this poses to security of tenure:

> Even before the investment becomes an actual loss the return reaches a level that is less than can be obtained in the financial market place with an amount of capital that is equivalent to the property value, and it is at that point that the landlord is forced to seek a way of changing his financial return, as — indeed — would any of us! A continuation of an annual rental increase of only 6% will obviously ultimately force our landlord into exercising the right he already has of selling "our house" and that would put us out. With an available

> rental accommodation of far less than 1% at this time in Metropolitan Toronto, where does a family of four live? With the very strong desire, for very many reasons, to live in a house rather than an apartment but without the ability of being able to buy a home, where does a family of four live? With the need of having to live in Metropolitan Toronto in order to be able to keep my job, where does a family of four live? With the only rental houses now being constructed in or around Metropolitan Toronto being "luxury" accommodation at rental rates higher than the maximum amount at which such rentals fall within the "protection" of the Act, and thus out of reach of families such as ours, where does a family of four live? (Brief 89, pp. 3-4)[2]

2. Affordability Issues

In many briefs, concern is expressed for a balance between landlords' need to achieve an adequate return on investment and tenants' need for affordable, secure housing. For those on low or fixed incomes of particular concern is the prospect of having to pay an unaffordable rent because there is no alternative affordable accommodation. One brief states:

> An apartment represents to many the same sense of home and security as a house and any major threat to that security is fundamental in nature and socially damaging. Major rent increases impact most severely on those whose income cannot expand, such as retired persons, especially when economic alternative accommodation is not available. Many of our residents are in this unfortunate position and although their own apartment building may not be subject to major rent escalation [in the] near term, the environment and experience of others will cause great concern and in some cases despair. (Brief 49, p. 1)

Another comments:

> Over the past few years accommodation costs, whether for rented or purchased homes, have increased at an alarming rate. At the present time, we are reaching a crisis situation in which many people simply cannot afford adequate housing. I have spoken to a number of tenants, many on fixed incomes who simply cannot afford the 15% rent increase being requested in the Parkway Forest complex. Futhermore, our economy as a whole is threatened when such a large proportion

> of so many incomes is going in one direction - to the land developer. Little or no money is left to spend elsewhere - to buy products which must be purchased in order to create jobs so our faltering economy can survive. (Brief 50, p. 1)

The availability of affordable accommodation continues as a key concern. A brief from the 45 Grenoble Drive Tenants Association says:

> An important issue facing the Ontario Legislature in its current discussion of policy options for continuing tenant protection is to what extent the rents are forecast to increase and to what extent they should rise to assure an adequate supply of rental housing in the absence of the rent review program.

Further:

> It appears that those tenants who are in the labour force and earning at least average wages can afford the rent increases that have been experienced during the past five or six years; however, those living on fixed incomes or who may be earning much less than the average wage cannot. The goals of improving the economics of rental construction conflict with the goal of making rental housing affordable to those with low incomes. The Legislature will have to weigh these objectives heavily before opting for one or the other. (Brief 65 p. 3)

The Inquiry noted the considerable amount of concern expressed that even with a rent regulation program, affordability is still an issue.[3] One brief comments:

> . . . that rent increases have outstripped wage increases in recent years; that thousands of tenants have experienced large and often crippling rent increases, both under the provisions of the *Residential Tenancies Act* and due to exemptions under the Act. (Brief 51, p. 1)

The nature and extent of exemptions is discussed in many briefs. For some a specified monetary exemption is insensitive to affordability concerns (Briefs 25, 34, 39A, 45, 72, 76A, 93, 108) while others suggest (Briefs 85, 95) that certain types of exempt units such as those in buildings built after 1975 be included (the 1986 Act now extends to post-1975 construction) and units in educational institutions (20, 54).

On the rent review exemption which existed for post-1975 buildings at that time, the Social Planning Council of Ottawa-Carleton comments:

> This exemption was presumably intended to remove any disincentive to new construction, which would in turn reduce vacancies and consumer choice. It should be noted that vacancy rates before and after the introduction of rent review have remained remarkably stable, except in the recent period of very high interest rates, when they dropped to zero in Ottawa-Carleton.
>
> This exemption means that, for an increasing portion of rental housing stock, there is no recourse to rent review. Given the current excess demand in markets such as Ottawa this exemption has probably allowed windfall profits and has created an artificial incentive to demolish or convert older stock. It may also have tended to increase pressure on reviewable rents by virtue of the psychological impact of rent increases on landlords and tenants alike.

They continue:

> Rent review should be applicable to post-1975 stock but should be introduced in such a way as to give a newly constructed building some time to establish its rent structure at a fair level. This may be accomplished by allowing new rental stock a period of time to find its place in the market. When a new rental complex comes on stream it will have a higher cost structure than exactly the same building built earlier. The new supplier will charge high end market rents that may not cover his costs. As time passes this supplier's position will improve as inflation erodes the real cost of his financing. He will also, increasingly, be in a more favourable competitive position whith respect to newer buildings. At a point he will attain a positive cash flow and be able to realize a reasonable return on his equity. (Brief 95, 5-6)4

For some, the availability of affordable accommodation is exacerbated by rent review. (Briefs 8, 27, 30, 31, 72, 91 and II-2, 5) Others see the problem extending beyond rent regulation to the need for a more extensive housing policy to address housing shortages and needs on a broader scale (46, 95, SPCMT (1985)).

One group recommends the provision of additional rental housing:

> . . . through non-profit housing programs to increase the vacancy rate to the point where market competition will keep the cost of market housing at a reasonable level without the need for rent review interventions. (Brief 85, p. 3)

According to the Canadian Institute of Public Real Estate Companies (CIPREC), many needy households cannot obtain affordable housing.

> Without belabouring the point, it is self-evident that rent controls are an ineffective way of providing assistance to low-income tenants who would otherwise face hardship in finding acceptable accommodation.
>
> There has been considerable discussions in both the public and private sector about the viability of developing a shelter allowance program for tenants facing affordability problems. Such an approach would certainly be better focused than the existing rent control regime, and ensure that well-off tenants did not inadvertently receive "windfall" subsidies they do not require.

They continue:

> There are always individuals and families who need support to attain an acceptable standard of living. In our view, the issue is *need* — not whether the individual or family is in tenancy. (Brief II-2, p. 34, emphasis in original)

The Ontario Real Estate Association observes:

> Needy tenants are not receiving the volume of assistance they require through rent review.
>
> It is evident that there is a basic core group of tenants who cannot afford to pay unsubsidized rents but who are either ineligible for or are unable to obtain subsidized rental accommodation — from the statistics presented earlier, it would appear that somewhere between 15 percent and 25 percent of all tenants are in this group. While these needy tenants are, no doubt, benefiting from rent review, it is a very ineffecient process:
>
> — most needy tenants do not benefit enough from rent review to improve their affordability situation substantially — only direct subsidies could achieve this; and
>
> — the majority of tenants receiving the rent reveiw assistance are not needy tenants.

They continue:

> As a general rule, newly forming households tend first to rent and then, after some years of saving up a downpayment, they purchase a home of their own. The poor economic conditions and the rise in mortgage interest rates of the past 3 years in combination with the fact that the relative costs of renting are now vastly lower than those of owning have led to a situation where some prospective first-time homebuyers are postponing their decision to purchase.

One consequence of this is a reduction in availability of controlled units. They comment:

> . . . the stream of vacant units which has traditionally resulted from the movement of first-time homebuyers from rental to ownership is no longer as large because of the reluctance of potential buyers to leave their inexpensive rental accommodation. This is a contributing factor in the very tight rental markets which prevail today. (Brief 91, p. 2)

Shelter allowances were advocated in a number of other briefs as a means of housing those with affordability problems (for example, Briefs 16, 26). Other briefs (27, 30, 72A, 91, 110, II-2, 3A, 5, and SPCMT (1985)) made suggestions on ways to increase the supply of housing directed to those in need.

3. Effects on Existing Stock

Implicitly, many briefs start from the premise that rent regulation is effective in reducing rents and, hence, reduces the profitability of rental housing investment. From there, they look at such consequences as depressed capital values (Briefs 2, 31, 98) and negative impacts on the willingness to invest, or to continue to invest in rental housing (30, 72, 91, II-2). Still others examine strategies aimed at minimizing or reducing investor losses. Such strategies include changes in service and maintenance levels (9, 11, 12, 25, 82, 85, 87), illegal rent increases (23, 30, 35, 36, 46, 90, 113)5 and efforts to seek alternative investment options, some of which may involve renovation, conversion or demolition activities (Briefs 40, 46, 49, 75, 81, 89, 106, 108, II-2 and 4).

On deterioration of the rental housing stock, CIPREC comments:

> It is obvious that rent controls limit the profits of landlords. The results of this constraint however, are not as apparent. According to

> a recent report prepared for the Ontario Ministry of Municipal Affairs and Housing, landlords are being forced to postpone or minimize expenditures on conservation and maintenance of their units to ensure a reasonable rate of return on their investment.
>
> Because of the long term nature of the buildings in Ontario, so far this process of deterioration has only just begun. Unfortunately, once several more years have elapsed, the run-down condition of the buildings may be largely irreversible and, ultimately, it is the tenants themselves who will suffer from a lower quality of accommodation than has been enjoyed in the past. (Brief II-2, pp. 26-27)

4. Effects On New Supply

Four key issues related to the effects of rent regulation on the supply of new rental housing were identified in the briefs submitted to the Inquiry.

The first issue relates to the perceived risk (now realized) of the extension of rent controls to those buildings constructed after 1975.

> At present, buildings constructed since 1975 are not subject to rent control. This date must not be advanced even one year as, if it were, landlords would lose complete confidence in the system and would not risk any more building in case the rules changed again. (Brief 3)

The Shelter Corporation remarks:

> Controls restrict the ability of a property owner to adjust the rental rate structure of a building in accordance with changes in market conditions. They impose arbitrary limits on price levels and result in artificially low rental costs.
>
> Developers are unwilling to invest in a repressed market, where initial rents must compete with the artificially low rate structure of existing complexes. Rent controls significantly increase the amount of risk confronting a potential developer and create unacceptable investment conditions. This, in turn, discourages construction of rental properties and contributes to housing shortages. (In Brief II-2, p. 74)

A second issue relates to the availability of mortgage financing for rental properties. Several briefs suggest that financial institutions are hesitant to pro-

vide financing for new and existing properties (31, 80, 98, II-2). One of them comments:

> We have now arrived at a situation where many mortgage lenders are no longer interested in placing mortgages on rental apartment buildings. Indeed this writer has already experienced a situation where a major chartered bank refused to take an apartment building with high equity as collateral for a loan recently. This apparently is now stated bank policy. (Brief 98, p. 3)

Another puts it this way:

> This year with mortgage rates dropping we hoped that the building would at last pay its own way. But now we have run into a problem that is a direct result of the Residential Tenancies Act. As you certainly must know, most banks will not touch a residential rental property mortgage. Victoria and Grey say they are prepared to give us a first mortgage *only* if we will insure it with the C.M.H.C. at a cost of $500 up front and 1 1/2% per thousand added to the mortgage ... Victoria and Grey have given us their reason for refusing us that they feel that their risk is too great on rental property. Even though the vacancy rate is low and the fact that [there are] six separate incomes (five tenants plus our personal income any four of which guarantees enough to pay the mortgage) they claim that GOVERNMENT INTERFERENCE IN THE RENTAL HOUSING MARKET HAS MADE IT TOO MUCH OF A RISK. [emphasis in original] (Brief 80, pp. 1-2)

A third concern is the loss of those individuals with expertise and good reputations as leaders in the development and management of rental properties and concern over the objectives and attitudes of those who will replace them. M. Walker (cited in Brief 30) comments:

> If you have buildings in a market that is rentcontrolled and the landlords who are there now are generally law-abiding people . . . and you have another individual who doesn't mind engaging in activities . . . which are close to being extralegal, the rate of return from investing in that building for the guy who is willing to undertake illegal activities is quite a bit higher than it is for the guy who is law-abiding. And there is an attraction for that kind of individual to come into the rental market. . . . The value of the building is depressed by rent controls and so it is an easy buy-in.

W. Krehm says:

> I know nothing about the purchasers of the Cadillac buildings, and I mean to cast no aspersions on them. What I do know is that the government helped drive out of the field a highly reputable concern like Cadillac-Fairview. And that is the merest tip of the iceberg. I could name a dozen other major developers who have left or who are looking to leave the industry. (Brief 31, p.6)

According to CIPREC:

> The worst consequence of rent control is the discouragement of new construction by the private sector which should normally be the most efficient and productive source of new accommodation. This negative impact is certainly true of the CIPREC group of companies and is regrettable since many of these firms have the experience, financial strength and technical competence to build rental units.
>
> Many who have contributed significantly to rental construction in the past have been forced to abandon it. Ironically, it is those same companies who are becoming quite successful in the U.S. where rent controls do not exist. (Brief II-2, p. 38)

David Mitchell comments:

> In 1975 if rents were too high (and the possibility that they were only occurred in Toronto to any extent), it certainly indicated only one thing, that there was a shortage of apartments. The shortage was caused mainly by the difficulty builders had in finding suitable apartment sites — again bureaucracy at several levels. Builders would be very anxious to build more apartments if there was an incentive. The most common incentive is profit - the more profit the more buildings, the more buildings the more competitive rents. As it is now there is no incentive to build new apartments. (In Brief 31)

A number of briefs, in providing analysis of reasons for low levels of new construction, focus on the gap between market rents and economic rents. The Ontario Real Estate Association in their brief make the following observations:

> The private rental market in Ontario does not work properly anymore. Despite very low vacancy rates for rental accommodation in most centres, little new rental construction is occurring. Landlords simply

are not willing to build new rental projects without very heavy subsidies from the federal or provincial governments.

Why has this happened?

Simply, while rents on most of the rental stock have been constrained from rising more than the statutory 6 percent since rent review was imposed, construction and financing costs have both increased dramatically along with general inflation. This has led to the current situation where the rents necessary to cover costs on a new rental property are so far above prevailing market rents that new rental projects are not viable — if built, these new projects will encounter severe market resistance.

Rent review does not restrict what rents new projects can charge, but the differential between the rents on new buildings and the rents on the majority of the existing stock is simply too large for the market to accept.

In the early years of rent review, both the federal and provincial governments recognized that this gap between market rents and the costs of new construction would constrain new rental investment. As a result, a number of rental investment incentive schemes were instituted which provided subsidies to landlords. These schemes allowed new projects to be viable with a lower rent structure and were successful in stimulating new rental construction.

The rental incentive schemes were extremely costly and have been gradually phased out and replaced by the less effective Canada Rental Supply Plan. [since terminated] This limited program has not resulted in a significant number of rental starts and is clearly not a long-term answer to the problems in the rental market. (Brief 91, pp. 1-2)

Campeau Corporation comments:

Rent controls have the effect of intervening in the marketplace, such that rents charged are less than what they would have been, had there not been a limit or ceiling put on them. Such an intervention upsets the supply and demand equation — supply is discouraged since economic rents are not available to developers and demand is increased due to lower prices as renters who would normally become purchasers maintain their tenancies.

The combined effect of rent controls is a decline in vacancy rates. The shortage of rental housing results in a large number of undesirable

> side effects, such as an increase in demand for government subsidies to encourage new rental construction, the development of black markets in rental housing, the cutting back of maintenance and repairs by property owners in order to maintain profit margins resulting in a deterioration of existing housing and as well, in overcrowding for those who cannot find suitable accommodations. (In Brief II-2, p. 60)

The Social Planning Council of Metropolitan Toronto in a publication entitled *Rent Review in Ontario and Factors Affecting the Supply of Rental Housing*, a copy of which was submitted to the Inquiry, argues that it is the impact of other factors, not rent regulation, which are the primary determinants of low levels of new rental construction. They make these concluding observations:

> We are now able to conclude that demographic factors resulting in decreased numbers of renters are chiefly responsible for declining numbers of apartment starts. Other demand and supply side forces seem to be largely responsible for the fact that new apartment starts have been lagging considerably behind the growth in renter households. On the demand side tenants are tending to come from lower income groups. The overall income of tenants has decreased considerably relative to incomes in general. Average tenant incomes have lagged behind both overall price levels and rents. On the supply side rental development costs and operating costs have increased more rapidly than rents or tenants' incomes. Financing costs have increased more rapidly yet, and the result is that the gap between average rents for existing buildings and for the break-even operation of new buildings has grown from 20 per cent of existing rents in 1968 to 85 per cent in 1981. Almost all of the wider gap results from increased financing costs. Only one-fifth results from the gap between rents and development and operation costs.
>
> The federal and provincial governments have responded to the decline in new rental housing starts with a variety of programs designed to reduce income taxes on investors and to subsidize loans. We have reviewed these programs above as well. The major conclusion of this review is that the subsidies have done little in themselves to increase new rental housing starts. Several studies have concluded that apartment starts are very insensitive to the loan subsidies provided. (pp. 36-37)

5. Distributive Issues

This final section of the Appendix briefly reviews the distributive issues related to rent regulation. It does so by noting the issues and then citing the relevant briefs. In some respects all the briefs can be divided into two main groups. Briefs from tenants and their organizations are commenting on the increased transfer of their income to landlords which occurs when rents increase more so than normal, particularly in inflationary periods combined with tight market conditions. Landlords and their organizations, on the other hand, consider the difference between regulated rents and rents in the absence of regulation as a transfer of their income to tenants.

Other issues presented in the briefs concern certain inequities present in the system. Landlords argue that they are providing the benefits of what should basically be a social housing program which should be paid for out of general tax revenues (Briefs 8, 16, 31, 72, 91, 103). Others concern what is perceived to be inequitable treatment of small landlords relative to large, corporate landlords (2, 9, 16, 48) or the treatment of landlords without regard to local market conditions (31, 115) or without regard to the level and quality of accommodation (6, 110).

A number of briefs argue that the majority of the benefits of rent reductions go to those households which are not in need and that many of those in need cannot secure regulated units which are occupied by higher income tenants (for example, see Briefs 30, 91, II-2). Finally, many of these same briefs consider the high cost of rent regulation in terms of administration costs, property tax reductions and other forgone tax revenues.

Appendix J

Research Studies

The following is a list of papers commissioned by the Inquiry.

No.	
1	Slack, Enid and Glied, Sherry. *Rent Registry Alternatives*, 1983.
2	Reid, Frank. *Collective Bargaining for Tenants*, 1984.
3	Jaffary, Karl D. *Problems in the Regulation of Rents for Roomers and Boarders*, 1984.
4	MacDonald, Daniel V. *Constitutional Reference Re; The Residential Tenancies Act*, 1984.
5	Fallis, George. *Possible Rationales for Rent Regulation*, 1984.
6	Hulchanski, J. David. *Market Imperfections and the Role of Rent Regulations in the Residential Rental Market*, 1984.
7	Sharp, Campbell, Pannell Kerr Forster Campbell Sharp. *Survey of Financial Performance of Landlords*, 1984.
8	Marks, Denton. *Housing Affordability and Rent Regulation*, 1984.
9	Steele, Marion and Miron, John. *Rent Regulation, Housing Affordability Problems, and Market Imperfections*, 1984.
10	Clayton Research Associates Limited. *Rent Regulation and Rental Market Problems*, 1984.
11	Makuch, Stanley M. and Weinrib, Arnold. *Security of Tenure*, 1985.
12	Hartle, D.G. *The Political Economy of Residential Rent Control in Ontario*, 1984.
13	Slack, Enid and David P. Amborski. *The Distributive Impact of Rent Regulation*, 1984.

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14 Knetsch, Jack L., Daniel Kahneman and Patricia McNeill. *Residential Tenancies: Losses, Fairness and Regulation*, 1984.

15 Stanbury, W.T. *Normative Bases of Rent Regulation*, 1985.

16 Stanbury, W.T. *Normative Bases of Government Action*, 1985.

17 Stanbury, W.T. and P. Thain. *The Origins of Rent Regulation in Ontario*, 1986.

18 Stanbury, W.T. and I.B. Vertinsky. *Rent Regulation Characteristics and Effects*, 1986.

19 Chant, John. *Overview of Alternative Rental Housing Policies*, 1986.

20 Foot, David K. *Housing in Ontario: A Demographic Perspective*, 1986.

21 Quirin, G. David. *Regulatory Systems and their Applicability to Rent Controls*, 1986.

22 Mascall, M. and Associates. *Report of the Ontario Rental Housing Market*, 1985.

23 Environics Research Group Ltd. *Financing Residential Rental Accommodation: A Survey*, 1985.

24 Ekos Research Associates Inc. *A Study of Landlords and Rent Regulation*, 1984.

25 des Rosiers, Francois. *A Rent Control Sytem in Quebec*, 1985.

26 Slack, Enid. *The Costs of Rent Review in Ontario*, 1986.

27 Muller, Andrew. *Workable Rent Regulation: A Synthesis*, 1986.

The following is a list of papers prepared by the research staff of the Inquiry.

28 Adams, Eric. B., Pearl Ing and John Pringle. *A Review of the Literature Relevant to Rent Regulation*, 1986.

29 Adams, Eric, B., Pearl Ing, Janet Ortved and Mary Jane Park. *Government Intervention in Housing Markets: An Overview*, 1986.

30 Pringle, John. *Ontario's Residential Tenancies: A Statistical Profile*, 1986.

Appendix K

Bibliography and Research Studies

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Adams, Eric, B., Ing, Pearl, Ortved, Janet. Park, Mary Jane. *Government Intervention in Housing Markets: An Overview*. Research Study No. 29. Toronto, 1986.

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Appendix L

Persons and Organizations That Submitted Briefs to the Inquiry*

G. Douglas & Thelma Aitcheson
Phyllis Akler
Ariadne Group 440556 Ontario Limited
    Edward J. Waitzer
    Joseph Berman
Avenue Plaza Tenants Association
    Kenneth D. Ryan
265 Balliol Street Tenants Association
    Penny Dickenson
657 Balliol Street Tenants' Association
    Kathleen J. O'Brien
Bathurst-Eglinton Tenants' Association
    Katherine Gardner
1840 Bathurst Street Tenants' Association
    Carolyn Dodds
Bayshore Tenants Association
    Daniel McIntyre
Sagar Bhardwaj
Don Boudria, M.P.P.
Bretton Place Tenants' Association
    Grant M. Hall
Olga Bugiel
Canadian Bar Association — Ontario
    Robert G. Doumani
Canadian Federation of Students — Ontario
    Helena Mitchell
Canadian Institute of Public Real Estate Companies

Michael Cassidy, M.P.P.
Cawthra-Mulock Tenants Association of
105 Isabella Street & 100 Gloucester Street
Helen I. Galbraith
Stanley Cerisano Limited
Jan Chaldron
Champlain Towers Tenants Association
W. Foster
Herbert C. Chappel
Dominic Chiocchio
City of Ottawa — Energy Action Plan Process
Evelyn Gigantes
City of Toronto — Department of the City Clerk
Roy V. Henderson
Ad hoc Committee of Tenants
Doug Draper
Community Legal Services — Ottawa-Carleton
Niculae A. Amarica
Committee of Concern for Rental Housing
Julius Melnitzer
Continental Tower Tenants' Association
Ralph H. Sarson
Sean Conway, M.P.P.
Sheila Copps, M.P.P.
Deer Park Residents' Association
Jane Hughes
Howard Joy
M.A. Richardson
Edward Morris DeWitt
1055 Don Mills Road — Tenants
John McGough
49 Dundonald Street Tenants' Association
Sarah Peters
Stewart East
Engineering Interface Limited
Ian A. Jarvis
Essex County Senior Citizens Retirees Council
George LaBute
Herb Epp, M.P.P.
Federation of Ottawa-Carleton Tenants Associations
Tom A. Trottier

Fink and Bornstein
    Richard A. Fink
Honourable Susan Fish, M.P.P.
    Flemingdon Community Legal Services
    John McKean
Franklin Apartments
    Don Barratt
Grandview Association of Tenants
    Kenneth Engmann
Guelph & District Apartment Owners Association
    Denzil Williams
Halam Park Development Limited and Janus Apartments Limited
    Robert Burton
Hamilton Wentworth Renters Network
    Mark Osborne
    James G. Wells
Hampton House Tenants Association and Rosedale East Tenants Association
    Raymond Stancer
Hayward & Poyser
    R.P. Hayward
    C.W. Poyser
Homestead Land Holdings Limited
    G.H. Stellar
I N A Financial Services, Inc.
    Jose Luis Baptista
108 Isabella Tenants Association
    Elinor Mahoney
Richard James
Anne Johnston
Ron Kanter
Jean Kanty
Graham R. Kidlark
Kingston Rental Property Owners Association
    Howard R. Shaw
La Salle Towers Tenants Association
    H. Kreplin, R. Snider
John Land Appraisals Limited
Claude Latremouille
Law Union of Ontario
    Jack Gemmell
    Paul Reinhardt
W.H. Lavery

Jack G. Layton
London and St. Thomas Real Estate Board
J.M. Rowcliffe
Remo Mancini, M.P.P.
Manor Gardens Tenants Association
Gary W. Zinck
Maple Lake Park Tenants Association
Frances A. Coates
Alan McLeod
McMaster University Tenants Association
Anthony L. MacFarlane, M.D.
McQuesten Legal & Community Services, Association of
South-West Legal Clinics
David Craig
Sarah Metrick
Minto Tenants Association, Parkwood Hills and Navaho Place Tenants Association
Sharan Mathieu
Sherrill Burns
Karel Moravec
Multiple Dwelling Standards Association
Jan Schwartz
Niagara Region Landlords Association
George Cottage
Ben Nobleman
Northgate Tenants Association
Jack Garson
Melissa Klein
Maria Senyk
Mark Tooker
117 Old Forest Hill Road
Margot Clark
Nazla Dane
Gertrude Templeton
Ontario Landlords' Association
David M. Shoesmith
Ontario Real Estate Association
O'Shanter Development Company
William Krehm
Parkway Forest Tenants' Association
Moira Jubinville
John H. Pavey

Peterborough and District Landlords Association
D. Cooper
Joe Peters
David R. Peterson, M.P.P.
Steve Plestina
Burns Proudfoot
Robert K. Rae, M.P.P.
Kenneth A. Roberts
Rosebury Square Tenants Association
Shalom Schachter
David Rotenberg, M.P.P.
Albert J. Roy, M.P.P.
Tony Ruprecht, M.P.P.
St. Andrews Towers Tenants Association
George H. Young
St. Clair Association of Rental Properties Owners
R. Brill
Seigniory Tenants Association, The Watergate Tenants Association L.-A. Couture
John Sewell
Yuri Shymko, M.P.P.
Small Landlord Action Committee
Bruno Kuhlmann
Social Planning Council of Metropolitan Toronto
Jeffrey Patterson
Social Planning Council of Ottawa-Carleton
Jim Goss
Rod Manchee
John D. Strung
Sudbury Community Legal Clinic
David G. Leitch
Tenants' Association of 44 Stubbs Avenue
N.H. Regan
Tenants' Umbrella Group
Community Legal Aid Services Program
Flemingdon Community Legal Services
Tenant Hotline
Metro Tenants Legal Services
Parkdale Community Legal Services
Scarborough Community Legal Services
Riverdale Socio-Legal Services
East Toronto Community Legal Services

Central Toronto Community Legal Services
Jane-Finch Community Services
Mississauga Community Legal Services Inc.
Downtown Legal Services
Federation of Metropolitan Toronto Tenants' Associations
Louis Tramontin
Two Ambassadors Tenants Association
Grant Edwin Edwards
University City Tenants Association
Fred E. Vance
V.S.R. Investments
K. & R. Chavali
Waterloo Regional Apartment Management
Rudi R. Vogel
Webbwood Tenants Association
53/57 Widdicombe Place Tenants' Association
Eleanor Brown
Samuel Wilkes
Wilson Holdings Partnership
Harry Houtman
Bill Wrye, M.P.P.

*Some persons and organizations submitted briefs only during one phase of the Inquiry's hearings. Appendix L is a review of the briefs submitted to the Inquiry during both phases.

Appendix M

Witnesses Who Appeared before the Inquiry*

Douglas Aitcheson
Phyllis Akler
Niculae (Nick) Amarica
Ib Amonson
John Andrade
Robert David Arsenault
Nancy Ayotte
Jose Luis Baptista
John Bassel
Gerry Bauer
Marcel Beaubien
Earl Berger
Fred Bever
Michael Bossin
Don Boudria, M.P.P.
Robert Burton
Pat Capponi
Michael Cassidy, M.P.P.
Maija Ceming
Parduman Parkash Chadha
Prof. John Chant
Herb Chappelle
Brian Charlton, M.P.P.
Dominic Chiocchio
Robert Church
Frances A. Coates
Karen Cohl
Sean Conway, M.P.P.
John William Cookson
Sheila Copps, M.P.P.
Kim Coulter
David Craig
Claude Dagneau
Nazla Dane
Prof. Francois des Rosiers
Ephraim Diamond
Abel Jack Diamond
Penny Dickenson
Carolyn Dodds
Robert G. Doumani
Joyce Duffield
Will Dunning
Gail Edmunds
Herb Epp, M.P.P.
Robert Eyer
Helen Fega
Richard Fink
Susan Fish, M.P.P.
Prof. David Foot
Bill Foster
Mike Foster
Reverend Eilert Frerichs
Albert Friedberg
Craig Fulton

Helen Galbraith
Michael Galway
Katherine Gardner
Jack Garson
Catherine Glen
Sean Goetz-Gadon
Peter Goring
James Goss
Jeff Gould
Tony Grande, M.P.P.
John Grassl
Frank Graves
Elspeth Heyworth
James W. Hoffman
Valerie Hoffman
Mary Hogan
Richard James
Martin Jelinowitz
Anne Johnston
Margaret Johnson
Richard F. Johnston, M.P.P.
Moira Jubinville
Ron Kanter
Marvin Katz
Ron Kellestine
Graham Ralph Kidlark
Jack Klein
Marlene Koehler
William Krehm
Bruno Kuhlmann
Joan Kuyek
George La Butte
John Lang
Claude Latremouille
Herbert A. Lavine
Jack Layton
Sidney Leibovitch
David Garth Leitch
Alan Levy
Mario Liberty
Joseph Locke
Elmo Luuk
Ian Macdonald
Kenneth John MacDonald
Elinor Mahoney
Ron Manchee
Michael Mascall
Sharan Mathieu
Janet McClain
Donald Marshall McCurdy
Dr. Anthony L. MacFarlane
Daniel McIntyre
John McKean
Alan McLeod
Sarah Metrick
Edward Miller
Hilda Miller
Frank Mills
Professor John R. Miron
Helena Mitchell
Mrs. Moore
Karel Moravec
Andrew Muller
Terry Murdy
Paul Murphy
Michael E. Nairne
Ralph Nash
Bernard Nayman
Ben Nobleman
Lee Ann Northcote
Kathleen J. O'Brien
Mark Stuart Osborne
Jeffrey Patterson
Nicholas Patterson
John Pavey
Joe Peters
Sarah Peters
David R. Peterson, M.P.P.
Mary Petrushchak
Ed Philip, M.P.P.
Jack Pollock
James Potts
Burns Proudfoot
Prof. David Quirin

Robert Keith Rae, M.P.P.
Paul H. Reinhardt
James Renwick, M.P.P.
Allan Richman
Anne Richman
Leslie Robinson
Wayne Rockliffe
George Ropchan
Stanley Rossby
David Rotenberg, M.P.P.
Jim Rowcliffe
Michael Rowland
Albert J. Roy, M.P.P.
Danuta Ruczynska
Hiam Rudler
Alfonso Ruggero
Tony Ruprecht, M.P.P.
Italo Sera
Shalom Schachter
Pauline Shapero
David M. Shoesmith
Yuri Shymko, M.P.P.
Enid Slack
Prof. Lawrence Berk Smith
Peter Smith
John Spence
Roger Starr
Prof. William T. Stanbury
Glenn Stansbury
Jan Stevens
Louise Stratford
Robert Strom
Betty Strong
Melvin L. Swart, M.P.P.
Alexander Szekeres
Murray Tate
Erica Thomson
David Thornley
Kenneth J. Timney
Mark William Tooker
Thomas Trottier
Fred E. Vance
Margaret Vago
Maynard Viinalass
Rudi R. Vogel
George Vosper
Kolt Weinberg
John Whitelaw
Phillip Charles Williams
Alexandra Wilson
Guy Wright
Bill Wrye, M.P.P.
Gary W. Zinck

*Some witnesses appeared only during one phase of the Inquiry's hearings. Material in this Report has been drawn from evidence given in both phases.

Briefs

Brief No.	*Name, Organization*
1	265 Balliol Street Tenants Association Penny Dickenson
2	Small Landlord Action Committee Bruno Kuhlmann
3	Homestead Land Holdings Limited G.H. Sellar
4	Jack G. Layton
5	John H. Pavey
6	Alan McLeod
7	Continental Tower Tenants' Association Ralph H. Sarson
8	Sagar Bhardwaj
9, 78	Waterloo Regional Apartment Management Rudi R. Vogel
10	Burns Proudfoot
11	Fink and Bornstein Richard A. Fink
12	117 Old Forest Hill Road Margot Clark Nazla Dane Gertrude Templeton
13	Ad hoc Committee of Tenants Doug Draper

14	Webbwood Tenants Association
15	Karel Moravec
16	St. Clair Association of Rental Properties Owners R. Brill
17	Cawthra-Mulock Tenants Association of 105 Isabella Street & 100 Gloucester Street
18	Olga Bugiel
19	Rosebury Square Tenants Association Shalom Schachter
20	McMaster University Tenants Association Anthony L. MacFarlane, M.D.
21	Grandview Association of Tenants Kenneth Engmann
22	657 Balliol Street Tenants' Association Kathleen J. O'Brien
23	John D. Strung
24, 83	Avenue Plaza Tenants Association Kenneth D. Ryan
25	University City Tenants Association
26	Guelph & District Apartment Owners Association Denzil Williams
27	Halam Park Development Limited and Janus Apartments Limited Robert Burton
28	Dominic Chiocchio
29	Susan Fish, M.P.P.
30	O'Shanter Development Company William Krehm
31	Peterborough and District Landlords Association D. Cooper
32	Joe Peters
33	Hamilton Wentworth Renters Network Mark Osborne James G. Wells
34	Bretton Place Tenants' Association Grant M. Hall

35	Northgate Tenants Association Jack Garson Melissa Klein Maria Senyk Mark Tooker
36	Law Union of Ontario Jack Gemmell Paul Reinhardt
37	Yuri Shymko, M.P.P.
38	Richard James
39	108 Isabella Tenants Association Elinor Mahoney
39A	Bathurst-Eglinton Tenants' Association Katherine Gardner
40	1840 Bathurst Street Tenants' Association Carolyn Dodds
41	Hampton House Tenants Association and Rosedale East Tenants Association Raymond Stancer
42	Claude Latremouille
43	Committee of Concern for Rental Housing Julius Melnitzer
44	Michael Cassidy, M.P.P.
45	Ron Kanter
46	Social Planning Council of Metropolitan Toronto Jeffrey Patterson
47	Graham R. Kidlark
48	Multiple Dwelling Standards Association Jan Schwartz
49	Deer Park Residents' Association Jane Hughes Howard Joy M.A. Richardson
50	Parkway Forest Tenants' Association Moira Jubinville
51	Community Legal Aid Services Program Flemingdon Community Legal Services Tenant Hotline Metro Tenants Legal Services

Parkdale Community Legal Services
Scarborough Community Legal Services
Riverdale Socio-Legal Services
East Toronto Community Legal Services
Central Toronto Community Legal Services
Jane-Finch Community Services
Mississauga Community Legal Services Inc.
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Federation of Metropolitan Toronto Tenants' Associations

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David Craig

53 I N A Financial Services, Inc.
Jose Luis Baptista

54 Canadian Federation of Students — Ontario
Helena Mitchell

55 Albert J. Roy, M.P.P.

56 Don Boudria, M.P.P.

57 Bill Wrye, M.P.P.

58 David R. Peterson, M.P.P.

59 Herb Epp, M.P.P.

60 Remo Mancini, M.P.P.

61 Tony Ruprecht, M.P.P.

62 Sheila Copps, M.P.P.

63 Sean Conway, M.P.P.

64 49 Dundonald Street Tenants' Association
Sarah Peters

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John McKean

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L.A. Couture

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69 Niagara Region Landlords Association
George Cottage

70 Two Ambassadors Tenants Association
Grant Edwin Edwards

71	John Sewell
72	V.S.R. Investments K.& R. Chavali
72A	Ariadne Group 440556 Ontario Limited Edward J. Waitzer Joseph Berman
73	St. Andrews Towers Tenants Association George H. Young
74	Manor Gardens Tenants Association Gary W. Zinck
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80	Jean Kanty
81	Hayward & Poyser R.P. Hayward C.W. Poyser
82	Wilson Holdings Partnership Harry Houtman
84	Franklin Apartments Don Barratt
86	Kenneth A. Roberts
87	1055 Don Mills Road — Tenants John McGough
88, 75	City of Toronto — Department of the City Clerk Roy V. Henderson
89	Samuel Wilkes
90	Phyllis Akler
91	Ontario Real Estate Association
92	Bayshore Tenants Association Daniel McIntyre
93	53/57 Widdicombe Place Tenants' Association Eleanor Brown
94, 85	Federation of Ottawa-Carleton Tenants Associations Tom A. Trottier

95	Social Planning Council of Ottawa-Carleton Jim Goss Rod Manchee
96	Minto Tenants Association, Parkwood Hills and Navaho Place Tenants Association Sharan Mathieu Sherrill Burns
97	Sarah Metrick
98	John Lang Appraisals Limited
99	City of Ottawa — Energy Action Plan Process Evelyn Gigantes
100	Stewart East
101	Community Legal Services — Ottawa-Carleton Niculae A. Amarica
102	Champlain Towers Tenants Association W. Foster
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112	Sudbury Community Legal Clinic David G. Leitch
113	David Rotenberg, M.P.P.
114	G. Douglas & Thelma Aitcheson
115	London and St. Thomas Real Estate Board J.M. Rowcliffe
II-1	La Salle Towers Tenants Association H. Kreplin
2	The Canadian Institute of Public Real Estate Companies Michael Galway

3	Essex County Senior Citizens Retirees Council George La Bute
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4	Louis Tramontin
5	Halam Park Development Limited and Janus Apartments Limited Robert Burton
	Social Planning Council of Metropolitan Toronto Jeffrey Patterson

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